104

CAPITAL GAINS TAX REFORM

HEARING

BEFORE THE

COMMITTEE ON SMALL BUSINESS
HOUSE OF REPRESENTATIVES

ONE HUNDRED FOURTH CONGRESS

FIRST SESSION

WASHINGTON, DC, FEBRUARY 22, 1995

Printed for the use of the Committee on Small Business

Serial No. 104–11

U.S. GOVERNMENT PRINTING OFFICE

88–544 CC WASHINGTON : 1995

For sale by the U.S. Government Printing Office
Superintendent of Documents, Congressional Sales Office, Washington, DC 20402
ISBN 0-16-047328-4

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CAPITAL GAINS TAX REFORM

WEDNESDAY, FEBRUARY 22, 1995

House of Representatives,
Committee on Small Business,
Washington, DC.

The committee met, pursuant to notice, at 1:30 p.m., in room 2359–A, Rayburn House Office Building, Hon. Jan Meyers (chairwoman of the committee) presiding.

Chairwoman Meyers. The committee will come to order.

Today, the committee will continue its examination of the capital gains tax reduction provisions contained in the Contract With America. As the Members will recall, on January 26, the committee heard from several small businesses and economic development specialists regarding the need for investment in small business and how that could be enhanced through some type of special tax treatment for capital gains. Our hearing today brings several economic experts before the committee to express their point of view on favorable tax treatment of capital gains as a means of stimulating economic activity and investment in small business.

I have asked the witnesses to comment on the capital gains tax reduction provisions in H.R. 9 and provide the committee with their assessment of whether or not reducing the capital gains tax rate would be a cost-effective way to spur investment in economic growth.

In addition, I have asked our expert witnesses to expound on whether or not an across-the-board cut in the capital gains tax would stimulate investment in all areas of small business growth or would a more targeted incentive be needed. Finally, I have asked the witnesses to testify as to their views of the capital gains tax reduction from the perspective of tax fairness.

I should point out that three of the seven witnesses testifying before the committee today are appearing at the request of the Ranking Minority Member, Mr. LaFalce. He submitted a list of several suggested witnesses for a hearing on the capital gains tax and those appearing today are the witnesses that accepted our invitation.

As I stated at our January hearing on this topic, I strongly support a reduction in the capital gains tax as a way to help stimulate investment in small business and as a step toward eliminating Federal tax policies which penalize savings and investment for the future.

I believe some of our witnesses will be providing data to the committee which supports this view. Others will present opposing information. The purpose of today's hearing is to gather competing

data on the capital gains tax so that Members can benefit from a broad range of knowledgeable experts on the projected economic benefit to small business of a capital gains tax reduction.

At this time, I recognize the Ranking Minority Member, Mr. LaFalce, for a brief opening statement.

Mr. LAFALCE. Thank you very much, Madam Chair. First of all, I would ask permission to have my entire statement placed in the record as if read.

Chairwoman MEYERS. Without objection.

Mr. LAFALCE. I want to thank you very much for having a balanced panel presentation on the issue. Capital gains has some excellent features, some great difficulties, too, and I think that the panelists you brought forward today will explore both the pros and cons of this very, very well.

There were a number of other individuals that could have been asked, too, which would maybe have imbalanced the panel. I didn't want to do that, but Robert McIntyre, the director of Citizens for Tax Justice would have provided data showing a sharp rise in the unemployment rate following the 78 and 81 tax cuts in capital gains; conversely, the jobless rate fell notably after the 1976 and 1986 capital gains tax hikes were enacted.

I don't know that it is critical to have him here, but he would have testified along those lines.

There is someone who would give interesting testimony for the State of New York, Michael Schler, past chair of the Tax Section of the New York State Bar Association. He noted the enhanced opportunity for tax sheltering under the proposal before us, and the unfairness and complexity of indexing capital gains.

He has testified that "every experienced tax lawyer who reads the indexing provisions of H.R. 9, immediately dreams up a half-dozen ways to beat the system and create a tax shelter that eliminates tax on unrelated income."

He further emphasizes by indexing only assets as called for in legislation and not liabilities, artificial tax deductions can be created with little or no out-of-pocket expenses.

Moreover, he would have pointed out, a fair application of indexing capital gains would have to compensate owners of savings accounts, owners of money market mutual funds, owners of Government bonds, et cetera, for the effects of inflation and the complexity of indexing would reach even an individual's simple calculations into massive calculations, buying a home, selling the family car or investing in an IRA. All of these are factors to be considered.

Madam Chair, an excellent article was written by Jane Bryant Quinn in Newsweek, U.S. News, and World Report. I have it in the office. I will submit it to you later for your review to see whether it is appropriate to be in the record. If so, I would like it included.

Thank you.

[Mr. LaFalce's statement may be found in the appendix.]

Chairwoman MEYERS. Thank you very much, Mr. LaFalce.

I would like to introduce our panel and moving left to right, Dr. Norman Ture, Institute for Research on the Economics of Taxation. Have I pronounced your name correctly?

Dr. TURE. Yes.

Chairwoman MEYERS. Dr. Henry Aaron of The Brookings Institute. Next is Gary Robbins of—I guess Mr. Sheldon Friedman is next, Department of Economic Research of AFL–CIO; and finally Mr. Gary Robbins of Fiscal Associates of Arlington, Virginia.

Dr. Ture.

TESTIMONY OF NORMAN B. TURE, INSTITUTE FOR RESEARCH ON THE ECONOMICS OF TAXATION

Dr. TURE. Thank you, Madam. Chair.

Members of the committee, I appreciate the opportunity to discuss with you the significant improvement in the Federal income tax that will be provided by enactment of Title I of H.R. 9. Both of the principal features of the proposed capital gains reform, reduction in marginal tax rates applicable to capital gains and the inflation adjustment basis, would contribute to moderating the unwholesome income tax bias against saving and would afford promise of additional efforts to eliminate it completely.

Small businesses are one of the principal sources of innovation and creation of new businesses and jobs in our economy. Creating new businesses, business growth, implementing the innovations on which economic progress so substantially depends requires access to saving. A society that is actively entrepreneurial and innovative must be able to draw on saving that is adequate to finance such efforts. Improving the prospects for small business growth, therefore, depends to an important extent on moderating, if not eliminating completely, the existing tax law's bias against saving.

The existing Federal income tax increases the cost of saving compared to the cost of current consumption. The tax treatment of capital gains and losses accentuates this bias which is exacerbated by the application of the tax provisions to nominal rather than inflation-adjusted gains and losses.

In the appendix to my statement I have tried to provide illustrations of the nature of this income tax bias against saving.

Taxing realized gains also impedes transactions in capital assets. An investor will be reluctant to sell assets in order to purchase other assets unless the present value of the expected net returns on replacement assets exceeds that of the expected returns on existing holdings by enough to defray the tax on any gain realized on the sale of the latter.

This locking-in effect imposes a toll gate charge on business mergers and acquisitions. Effective entrepreneurship involves moving out of a matured business into new ventures often by selling the business to others for whom it affords greater opportunities. Taxing the gain realized on disposition of the business raises the reservation price for the sale and tends, therefore, to deplete the resources that would otherwise be rolled over into new ventures.

The existing tax treatment of capital gains and losses also imposes a barrier to commitment of saving to innovative, therefore, high risk enterprises. Insofar as such ventures succeed, some of the resulting increase in the saver-investor's equity is taxed away if he sells all or part of that asset in order to shift into other innovative high risk ventures.

On the other hand, if the venture is unsuccessful, the saver-investor's loss is not fully deductible when realized. The result is to

accentuate the risk, hence to raise the cost of undertaking such enterprises.

Both the proposed exclusion from adjusted gross income of 50 percent of net long-term capital gains and the adjustment for inflation on the basis of capital assets would be significant improvements over the existing treatment of capital gains. The proposed deduction from adjusted gross income of half of net long-term capital gains would cut the marginal tax rates in half for individual taxpayers in the 15 and 28 percent brackets and provide smaller but still significant percentage reductions in the capital gains tax rates for people in higher brackets. The corporation's proposed reduction would cut the top rate on capital gains to 17½ percent from a top of 35 percent.

The proposed 50 percent gain deduction would make an important contribution to move the tax system in the direction of neutrality between saving and consumption uses of income. It would, in other words, significantly reduce the extra cost of saving relative to consumption.

This highly desirable effect on the cost of saving would not be confined to saving invested in capital assets as defined in the Internal Revenue Code. Reducing the marginal tax rate on capital gains will reduce the cost of saving invested in capital assets and in all other uses, as well. The extent to which any business or industry will benefit from these developments is not readily determinable, but neither is this an appropriate public policy concern.

The distribution of these benefits should be determined by market operations not by Government dicta. Public policy should not attempt to target particular activities, businesses, industries, or taxpayers for Government-granted benefits or incentives. Policymakers should realize that every such selective benefit or incentive raises costs for those who are not the favored targets. These are the real costs of selective tax and spending measures.

The desirability of reducing marginal tax rates on capital gains does not depend, in my judgment, on how large the savings response to the overall lower cost of saving will be. The objective of this reform should be to reduce the existing antisaving bias. Reducing capital gains taxes is constructive tax policy, whether the resulting increase in saving is great, small or in between.

I believe that reducing taxes on capital gains will indeed result in significantly increasing saving compared to what would otherwise be undertaken. Sound economic analysis urges that tax changes that reduces the cost of saving relative to consumption uses of income will lead to a higher level of saving than otherwise occurs.

Reducing the marginal rate of tax on capital gains will ease the lock-in effect which I spoke of, reducing the tax impairment of the market's function in facilitating the exchange of property rights. The lock-in effect of capital gains treatment erects barriers to the efficient transfer of business ownership. The proposed 50 percent reduction in the corporate capital gains tax rate will materially reduce tax barriers to changes in corporate ownership as well as free up individual's property holdings.

Business restructuring, the concomitant of a dynamic economy, often involves changes in company ownership. One of the cost of

those changes is the tax on the capital gains realized in the process. Reducing that tax will facilitate productivity—thereby enhancing corporate restructuring. It is, therefore, extremely important to retain the inclusion of corporate capital gains within the purview of Title I.

Adjusting asset bases for inflation would forestall the adverse effect of the risk of inflation on saving and investment. Indexing the bases of capital assets for inflation will free up locked-in savings and will therefore enhance the efficiency with which the capital market performs its functions.

One of the major deficiencies of the existing tax treatment of capital gains and losses is their asymmetrical treatment. For individuals, taxable capital gains realized in any year are fully subject to tax in that year but net capital losses are not fully deductible in the year in which realized. Instead, net capital losses may offset no more than $3,000 of ordinary income in the year in which they are realized and unused capital losses may be carried forward until fully used up, but they may not be carried back. Since a dollar in the future is less valuable than a dollar today, this accentuates the asymmetry in the tax treatment of losses compared with gains.

Even harsher is the treatment of capital losses sustained by corporations. Corporations may offset capital losses realized in any particular year against the capital gains realized in that year but none of these losses, if in excess of capital gains, may be offset against ordinary income. Unused losses may be carried back up to 3 years and carried forward up to 5 years.

Changes in property and business ownership do not always result in capital gains for the sellers. The existing law limitations on the deductibility of capital losses, particularly in the case of corporations, significantly impede transfer of property rights to more productive uses and thereby blunt efficient response to the opportunities and challenges that continuously arise in the dynamic business environment. I hope that the Committee on Ways and Means in this House will address this deficiency in existing law.

Finally, a word about the fairness issue. Congressional consideration of tax proposals aimed at reducing tax barriers to saving, capital formation, entrepreneurship, has far too often been blocked by redistributional assertions that such proposals are unfair because they would benefit rich people and/or business. It is well past time for policymakers to recognize that the goodness or badness of a policy does not depend on the specific attributes of the people who are immediately affected by them.

A tax change that reduces the existing tax penalty on saving compared with consumption uses of income is not unfair because it may very well more substantially reduce the tax liabilities of people who pay a great deal of taxes and who will greatly increase their saving in response to the tax change than it will the taxes of people who pay little or no taxes.

There is no meaningful social, let alone economic policy goal that is served by punitively taxing saving. Such punitive taxation is not made "fair" because its weight is greater on the rich or business than on others. When one considers that the principal beneficiaries of increases in saving, capital formation, entrepreneurship, and other growth-generating activities are labor and consumers, redis-

tribution objections to easing the differentially heavier tax burdens on those activities in my judgment should be dismissed out of hand.

Addressing the unfairness in more heavily taxing income that is saved than income used for current consumption promises substantial dividends and higher standards of living for everyone. Title I of H.R. 9 is, in my judgment, an effective beginning.

Thank you.

[Dr. Ture's statement may be found in the appendix.]

Chairwoman MEYERS. Thank you very much, Dr. Ture.

Dr. Aaron.

TESTIMONY OF HENRY AARON, BROOKINGS INSTITUTE

Dr. AARON. Thank you very much, Madam Chair. I don't know how long we will be running. I want to apologize at the outset because I am going to have to leave at 2:30 to go back to do something for the people who pay me for a living.

I would like to refer back to something that Congressman LaFalce called our attention to. He reminded me of testimony given by Ron Pearlman recently to the Senate Finance Committee. Ron Pearlman, as you may know, has very good bipartisan credentials. He was President Reagan's Assistant Secretary for tax policy early in his administration; he was subsequently appointed by the Democratic Congress to head the Joint Committee on Taxation. I think people on both sides acknowledge that Ron tends to call it straight.

He warned about the risks of encouraging tax avoidance from enacting the particular indexing proposals that we are discussing here today.

I would refer you back to his testimony for more detail.

Let me begin with an analogy. I have been trying to think about how to present what I think is the structure of the issue.

Let us suppose that Congress simultaneously did two things: It instituted a universal subsidy for food consumption and undertook measures to reduce the supply of food. What would you expect to happen?

You would expect demand for food would go up, but since the supply didn't grow, indeed, it was reduced, the price of food would go up and total food consumption would fall.

That example is an exact parallel to the issues relating to the proposals to reduce tax rates on capital gains. To motivate that discussion, I would ask you to look at a series of graphics that I have attached at the back of my testimony at the back. I am not going to go through all of them, but I would like to focus on a couple.

The first graphic lists what I believe is a fair accounting of the categories of arguments pro and con, on whether it would be desirable to reduce the statutory rate on income from realized capital gains.

The arguments relate to economic growth, the issue of the effect on saving, the effect on investment demand and the effect of supply of venture capital. As far as fairness is concerned, I am referring here to the concept of what economists call horizontal equity, equal treatment of equals. We don't currently index the definition of income. We do index the rate structure, but not the definition of income. This failure is generally accepted as an inequity. We do have

a double taxation problem arising from the fact we tax income once at the corporate level and again when that income is paid out to individuals.

A final point made by some advocates is if you have a tax cut that doesn't lose any revenue, everybody is better off and you have to grab it. I think that argument is valid.

So, this first graphic just lays out the issue.

The second graphic is intended to clarify the current tax treatment of capital gains. The current top statutory rate is 28 percent. Roughly half of all capital gains are never realized during the taxpayer's lifetime; they are transferred at death and there is a step up of basis so the gain during the initial holder's life is untaxed.

I am referring to charts at the back of my statement, the very rear.

Chairwoman MEYERS. I am trying to figure out what you are looking at.

Dr. AARON. That means if one is looking across all capital gains, the effective rate of tax averages about 14 percent not 28 percent.

In addition, the typical capital gain that is realized is held on the average for about 4 years. These are data that have been produced by analysts with no particular axe to grind one way or another.

Deferral of tax liability is a reduction in the effective burden. If you don't believe that, I would ask you to give me $100 dollars and I will give you the $100 back in 4 years.

If you use an 8 percent discount rate, 4 years of deferral reduces the average effective rate about a quarter, taking down the average rate on all capital gains to a little over 10 percent. For the category of equities, a little under a third are held by tax exempt entities and thus the average rate on equities is taken down further to just over 7 percent.

The point of this chart is that capital gains relative to ordinary income already are favored in the tax code. The real issue before this committee and before Congress, therefore, is not whether capital gains should be treated more favorably than other income. They are already. The question is whether the advantage capital gains enjoy should be increased.

Norm Ture mentioned it would be inadvisable to favor firms or activities. But, the relatively favorable current treatment of capital gains and, even more, the liberalization of that treatment now being proposed, disproportionately favors real estate and would tend to cause a shift of investment in that direction because real estate typically, given the modes of operation, tends to generate relatively large volumes of capital gains. If you think shifting capital into the direction of real estate is what this country needs, then this is a plus for this proposal. If you don't, it is not.

I would like to dwell on the third graphic because it is the one that takes me back to my food analogy.

If we want to promote economic growth in the United States, increased wealth for American taxpayers and citizens, the vehicle for doing that is an increase in domestic investment, what I have signified by "I sub D" in this chart. Domestic investment is identically equal to two quantities. The first is national saving, which is the difference between private saving, S, and the Government deficit, D.

But in addition to that source of funding for domestic investment, we can borrow funds abroad. That is we can increase our trade deficit. Those are the last two symbols at the top. Foreign borrowing can support domestic investment, but it has negligible value overall for the American economy because the income from that investment, the marginal addition to U.S. productive capacity, flows to foreign owners, not to U.S. citizens and residents.

Therefore, the critical question in determining whether changing any capital tax rule—this doesn't apply just to capital gains—is, does it increase, U.S. national saving. That is analogous to increasing the food supply. I am prepared to stipulate that cutting capital gains rate will somewhat increase investment demand. But if the demand is not met by an increased supply of capital, there will be no gain to the American economy as a whole.

Now, that is the important point of graphic 3. I would urge you in thinking about the various arguments each of us is making, to keep this identity at this in mind. This is not politics, this is not Democratic politics or Republican politics or Democrat or Republican economics. This is Department of Commerce national income accounts.

Now, as far as investment demand is concerned I come to graphic 4. The issue here is: Would a capital gains cut favor U.S. domestic investment?

This one is easy. You look at the law. It treats capital gains on assets, wherever located, in the same way. So, there is an encouragement to investment demand, but no relative encouragement to U.S.-based investment. For that reason, one should not expect the proportion of U.S. owned investment located in the United States to increase.

So, that is another reason why you can't expect the proposal to raise U.S. based investment unless it raises U.S. savings. It is not going to shift investment from abroad to the United States.

Graphic 5—presents estimates that I believe are favorable to those who hold that cutting capital gains rates will boost U.S. private savings, what I called "S sub P" in the third graphic.

There is some arithmetic behind this, but the key is that I use is the estimate produced by Michael Boskin, President Bush's Chair of the Counsel of Economic Advisers, concerning responsiveness of private saving to changes in the rate of return. Professor Boskin's estimate is at the upper end of empirical estimates of responsiveness. So I am not stacking the deck toward a low estimate of the total effect.

Based on that calculation, the total effect on U.S. private saving would be an increase of somewhat under $2 billion per year. If one uses other empirical estimates, the estimates would be somewhat smaller.

In fact, there is no reason in economic theory to believe that a cut in capital gains rates will raise saving at all. It could raise it, it could lower it. Which happens is an empirical question. The empirical estimates are widely dispersed and this one is at the upper end of the range.

Next one comes to the other part of the equation that determines what happens to national saving. National saving is private saving less the Government deficit.

Private saving goes up $2 billion, what happens to the deficit?

The story here is given to you by the Department of the Treasury and by the Joint Committee on Taxation who, with respect to the rate cut proposal. By the end of the estimating period that they have done their work for, the revenue loss from the rate cut alone would be on the order of $10 billion a year. I believe you may hear some testimony later on suggesting that there are reasons to think that the actual loss would be even larger.

Nonetheless, taking that revenue estimate as the one to work from, we start from an increase in private saving of $2 billion, an increase in the deficit of $10 billion and therefore a reduction in U.S. national saving of about $8 billion.

Now, that completes the analogy with the food story I gave. Some increase in investment, some reduction in the supply of savings domestically to support that investment. We may borrow more abroad but we will pay out the net increase in U.S. production to foreign owners. Hence, on balance, the capital gains rate cut represents a drag, not an encouragement, to U.S. economic growth.

I think it is important to confront the savings story that I have been telling. If you can't get around it, you can't get to a growth story.

I will not go into the other graphs unless you would like to address them later on, other than to point out the equity issues that Dr. Ture raised in his comments.

We want to define income accurately and there are a host of problems with the current methods of defining income. One needs to be very careful in correcting one flaw that one doesn't open up other difficulties.

Indexing just capital gains assets would create enormous opportunities for tax avoidance. The mind absolutely boggles at the opportunities. I would consider going back to law school, even at my late age, to learn to become a tax lawyer because of the opportunities indexing would present for structuring transactions in extremely profitable ways for tax avoidance purposes. There is also the issue of what economists and others call vertical equity, the effect on income amongst various income classes. This is not a matter on which there is objective truth. People have different opinions about what a fair distribution of income is. All that I can suggest as an economist are certain facts to keep in mind.

For the past 20 years there has been no growth in average earnings of American workers. People in the bottom three deciles of the Americans' earnings distribution have experienced large earnings declines.

One group within society has enjoyed significant earnings and income growth and that is the top decile of the income distribution and in particular the top centile, the top 1 percent. Income growth has been really very handsome up there over the past 2 decades.

Half of the benefits from the rate cut on capital gains would go to the top 1 percent of income recipients. Let me stress here that I am not talking about the top 1 percent in any given year, but the top 1 percent averaged over a 5-year period. The fact that capital gains pushes your income up one year and it comes back down another year has been adjusted for to the extent that averaging over 5 years does that.

The bottom 80 percent of the income distribution receives about 10 percent of the benefits.

Now turning from fact to opinion, my own opinion is that is not the kind of income shift that is called for at the present time. But that reflects a certain distributional judgment on my part and others are free to disagree and there is no objective way I can say they were wrong.

[Dr. Aaron's statement may be found in the appendix.]

Chairwoman MEYERS. Thank you very much, Dr. Aaron.

Mr. Friedman.

TESTIMONY OF SHELDON FRIEDMAN, DEPARTMENT OF ECONOMIC RESEARCH OF AFL-CIO

Mr. FRIEDMAN. Thank you very much, Madam Chairwoman, for this opportunity to testify. I should say at the outset that in case my following remarks are not sufficiently clear, that I strenuously oppose any further cuts in tax preferences accorded to capital gains. Those existing preferences, as Dr. Aaron has noted, are already very, very considerable.

The yardstick I would like to use to evaluate the proposed cuts in the capital gains tax rate are, first, its impact on fairness; second, its budget impact; and third, whether or not it would stimulate productive investment, economic growth and create or retain more good jobs.

Fairness is very important as a yardstick for evaluating any tax policy proposal. From the standpoint of working people, it is inherently terribly unfair to tax their wages and salaries at a higher rate than the capital gains realized by the wealthiest individuals in our society.

The fact of the matter is capital gains tax preferences simply are not available to the overwhelming majority of working men and women in our country today. These people who form the bedrock and backbone of our economy have to go to work every day, get their paycheck every week and pay their taxes every time they get their paycheck. They simply don't have these tax preferences that are afforded to the recipients of income from capital gains.

There are already a wide variety, in my view, of highly unjustified tax preferences afforded to capital gains income in our tax code today. To take just a few important examples, and this list is by no means exhaustive, the 1993 increase in the top income tax rate to 39.6 percent left the top rate on capital gains at 28 percent, opening up an 11.6 percent wedge, a very large differential between the top rate on ordinary income and capital gains.

A brand new preference, furthermore, was created in 1993 for a variety of new investments which have a top capital gains tax rate now of only 14 percent.

Moreover, capital gains are untaxed at death if not realized at that time which is a way by which billions and billions of dollars of capital gains are passed from one generation to the next without a dollar of tax ever being paid.

As Dr. Aaron noted very, very correctly, the combined effect of these and other preferences is to reduce the effective tax rate on capital gains already to an extremely low level in our economy today. It is hard to overstate how skewed in favor of the wealthy

these existing tax preferences are. If you look at the richest 1 percent of the families in our country, those making $200,000 in income per year and up, they derive 22 percent, more than a fifth, of all their income from capital gains. This same group, the richest 1 percent, derives roughly two-thirds of all the income from capital gains generated by our entire economy. This privileged elite makes 50 cents in capital gains for every dollar they make in wages and salaries.

Now, let's take a look not at the bottom, necessarily, of the income spectrum, but at the fourth quintile, those in the 60 to 80 percent range in income—middle to upper-middle income folks. You can see what a gap there is between what the rich receive in capital gains and what even relatively well-off middle class Americans receive in capital gains.

If you look at those in the fourth quintile, they derive only 1 percent of their income from capital gains compared to the 22 percent for the richest 1 percent. For every dollar that the fourth quintile makes in wages and salaries, they derive only 2 cents in income from capital gains. A remarkable disparity.

In view of these kinds of numbers, it is scarcely surprising that 96 percent of all the tax benefits from the current 28 percent maximum capital gains rate accrue to just the richest 1 percent of taxpayers in our economy.

Against this backdrop, the further deep cuts in capital gains tax rates proposed in H.R. 9 would make a bad situation dramatically worse. The huge 50 percent reduction in capital gains tax rates coupled with indexation would exclude almost two-thirds of all capital gains income from taxation. In a typical example provided in recent Treasury Department testimony, the effective tax rate on income from capital gains would amount to less than 9 percent. Fully 70 percent of all these benefits from the proposed capital gains tax cuts in H.R. 9 would accrue to the richest 1 percent, those making more than $200,000 a year for whom these tax breaks would be worth on average $16,000 a year.

Proponents of capital gains tax cuts attempt to dismiss these kinds of criticisms by terming them evidence of envy or attempts to foment class warfare.

These criticisms simply are not accurate. Envy is not the same as fairness, which lies at the heart of the debate around taxation of capital gains. It is simply not fair to tax the capital gains of the wealthy at a preferential rate compared with the hard-earned wages and salaries of working people. It is not class warfare to suggest that the most economically fortunate Americans who derive the greatest benefits from our economic system should pay their fair share of taxes that are needed for that system to function effectively.

Let me turn briefly to the budget impact of the proposed capital gains tax cuts. I know you have probably all seen the Treasury Department estimates according to which the capital gains cuts would deprive the Nation of $61 billion in revenues over the next 5 years, a cost which would swell to $183 billion if you consider the next 10 years.

The dogged insistence by some proponents that deep cuts in capital gains would not cause revenue losses is sheer economic non-

sense. Beyond the revenue loss and the inequitable distribution of the proposed capital gains tax cuts, I have very serious concerns about how the cuts would be financed. The elaborate detail of the capital gains tax cuts as proposed in H.R. 9 stand in marked contrast to much of the rest of the Contract With America, which fails to identify specific spending cuts to pay for those and other tax cuts.

While it is true that a high proportion of the American public express understandable frustration to pollsters by advocating less Government, most people do not favor cuts in specific programs such as education, job training, health care or transportation, and with good reason. Such programs can have a far greater bearing on the quality of their lives and economic opportunities than a tax cut, particularly a tax cut which will accrue almost exclusively to the most wealthy and privileged members of our society.

Despite the inherent unfairness and devastating budget impacts, these and other shortcomings would be less onerous if the proposed capital gains tax cuts could be counted on to stimulate productive investment, economic growth, and jobs.

Unfortunately, that is not the case. The fact of the matter is capital gains tax cuts have very little to do with productive investment as economists define it. Fully 97 percent of stock market transactions involve trading existing shares of corporate stock. These transactions are an enormous source of capital gains for wealthy investors, yet they don't provide the Nation's businesses with a single penny of additional resources with which to make real investment to retain or create jobs. Cutting taxes——

Chairwoman MEYERS. I am going to apologize because I have a vote in another committee. Mr. Torkildsen will take the chair and I think I will be back in a few minutes but I am not sure. Excuse me and thank you very much.

Mr. TORKILDSEN [presiding]. Proceed.

Mr. FRIEDMAN. Cutting taxes on these gains will not induce job creating investment.

Nor is there a guarantee that investment would occur in the United States. The U.S. tax code is already rife with provisions that reward corporations and wealthy investors for exporting or destroying U.S. workers' jobs. The last thing we need is another untargeted tax break which will further add to this problem.

Furthermore, if the Federal Reserve Board takes capital gains tax cuts or other tax cuts as a signal to raise interest rates as it very likely would, any possible benefit in terms of increased investment would be overwhelmed by the adverse impact of higher interest rates on economic growth and jobs.

With a theoretical basis this is shaky, it is not surprising that a number of empirical have failed to find any evidence for a connection between lower capital gains tax rates and higher productive investment to create or retain jobs.

The only economic activity that can reliably be predicted to be stimulated by capital gains tax cuts is the services of lawyers and accountants employed by the tax shelter industry. Tax shelters are often based on schemes to convert ordinary income into preferentially taxed capital gains.

As I noted before, the huge 50 percent differential contained in H.R. 9, coupled with indexing, will exclude almost two-thirds of capital gains income from taxation. This will prove to be an irresistible lure to many wasteful, revenue-losing and highly inequitable tax shelter activities.

Instead of further cuts in capital gains taxes, the better way to go would be to phaseout current preferences for capital gains. In particular, capital gains should be taxed at the same rate as ordinary incomes, and unrealized capital gains should be taxed at death. Safeguards could be added to prevent forced liquidation of assets, such as family farms, to pay capital gains taxes.

In summary, the capital gains tax cut provisions of H.R. 9 are not fair. They would have a severely negative impact on the Federal budget, and they would not stimulate productive investment, economic growth or the creation or retention of jobs.

Thank you for this opportunity to testify.

[Mr. Friedman's statement may be found in the appendix.]

Mr. TORKILDSEN. I thank you, Mr. Friedman.

Mr. Robbins.

TESTIMONY OF GARY ROBBINS, FISCAL ASSOCIATES OF ARLINGTON, VIRGINIA

Mr. ROBBINS. Thank you, Mr. Chairman. I am Gary Robbins, president of Fiscal Associates and the John M. Olin senior research fellow of Tax Action Analysis.

I appreciate the opportunity to speak to you today on capital gains provisions of the Contract With America.

The tax treatment of capital gains plays a large role in investment decisions of small business. Reducing capital gains taxes will expand investment opportunities for all businesses.

However, I would like to focus today on the issue of how much it will cost to expand these investment opportunities. My remarks summarize the study we have just completed for Tax Action Analysis which has been made available to the committee.

Over the next few weeks, the revenue effects of reducing capital gains taxes will play an important role in the policymaking process. The larger the revenue loss attributed to capital gains, the greater the spending reductions that will have to be made somewhere else making passage of the capital gains reduction more difficult.

The Joint Committee on Taxation has recently released its estimates of the cost of the capital gains proposal. The Joint Committee estimates that capital gains reductions called for in the Contract With America will lose $53.9 billion over the next 6 years and $170.3 billion over the next 10.

These estimates, however, are at odds with the experience of the last 7 years. Moreover, they point to an internal inconsistency in the methodology used by the Joint Committee.

The last major change in capital gains taxation occurred in 1986. At that time and for several years later, Government revenue estimators projected that elimination of the 60-percent exclusion would lead to a substantial revenue gain. By today, the change should be picking up somewhere between $30 and $40 billion in an additional revenue annually.

Tax return data, however, show that these revenue gains have not materialized. Instead, it appears that capital gains realizations are about 40 percent of what the Government estimators promised. In other words, taxable realizations are about the same today as they would have been under pre-1986 law.

Figure 1 of the Tax Action Analysis study—page 3 shows the realization predictions that the CBO and Treasury Department made versus what the actual outcomes have been. As You can see, the actual data are quite a bit below what estimators promised. This forecasting error has added $170 billion to the national debt over the last 5 years between 1990 and 1994. Today, this error accounts for roughly 20 percent of the current budget deficit.

Had the Congress in 1986 known that little of the hoped-for revenue would have been forthcoming, would it have raised the capital gains tax?

The capital gains proposal in the contract would go a long way toward restoring the pre-1986 capital gains treatment. Our study shows that using a modified version of the joint committee's method published in 1990, the total revenue effects of the contract proposal would be just about a wash. In other words, just as the 1986 increase picked up no additional revenue, the 50-percent exclusion proposed in the contract shouldn't lose any revenue.

Instead, it would encourage expanded realizations that offset the revenue loss on realizations that would have occurred under present law. Moreover, if as little as a quarter of the roughly $1 trillion in locked-in gains that have been building since 1986 are realized, revenues would increase by an additional $25 billion over the next 6 years. In short, there will be nothing like the $170 billion loss projected by the Joint Committee.

My discussion so far ignores the positive benefits of reducing capital gains taxes. In other words, the numbers to this point are on a static basis.

We estimate that the capital gains proposal would actually add roughly 4 tenths of a percent to the U.S. growth rate over the next 7 or 8 years, increasing output, investment and employment. But that is not crucial to my argument.

A capital gains reduction makes sense even without the growth argument. To reiterate, just as the 1986 capital gains change picked up little or no revenue, returning to something close to the old treatment would lose little or no revenue even on a static basis.

Given the missed call in 1986, policymakers should insist that Government revenue estimators review their methods, revise them where justified and make the findings public. In other words, any new revenue estimate should first look back at what it predicts would have happened due to the 1986 act. If it can't predict what happened this year, then it is not going to predict what is going to happen in the future. That is my message.

Thank you.

[Mr. Robbins' statement may be found in the appendix.]

Mr. TORKILDSEN. Thank you, Mr. Robbins.

I thank all the panelists today for your diverse and well thought-out arguments. I am going to start the questioning and I have a few for Dr. Aaron.

On graphic number 2, you mention that roughly half of capital gains are never taxed. Is that because of offsetting losses or are there other reasons there? Could you explain that in a little more detail.

Dr. AARON. Thank you very much. Yes, I will. It is largely because of step up in basis at death. They are held until the taxpayer dies. This is not because realized gains are offset against realized losses. May I interject one point because I regret I will have to leave sooner than I would like to, a comment on the point Gary Robbins just made. It is an important one to keep in mind.

One cannot look at the actual history of realizations of capital gains and learn what the effect of changes in capital gains rules is on Government revenues. One can learn what the pattern of realizations is, but there are three effects that capital gains concessions produce. First, they reduce tax on gains that would have been realized anyway. Second, they induce additional realizations. Everybody agrees to these effects, although they disagree on magnitudes.

The third effect of reduced rates on capital gains is to encourage people to recharacterize income—to convert interest income, wages and salaries in some cases if you are in a business where you can do it—from fully taxable income into capital gains.

In a sense, one could say if capital gains realizations increase when rates are cut, that could be symptomatic of revenue loss to the Government because of this recharacterization.

A second point to keep in mind in looking at the historical series is the last 3 years Congress debated pretty seriously whether it should cut rates on capital gains. If you were sitting on capital gains, what would you do? You would sit on them.

Mr. TORKILDSEN. A valid point. To follow up your line of thinking, couldn't you say the current system discourages corporations from paying dividends in order to put them into capital gains which are going to be taxed at a lower rate than dividends would be from a C corporation, for instance?

Dr. AARON. Yes, I think there is reason to believe current tax rules encourage retention. Whether shareholders take offsetting behavior in their own personal portfolio with respect to savings is very much at issue. If my portfolio appreciates in value, I consider that in planning my personal consumption.

Mr. TORKILDSEN. Quickly——

Dr. TURE. Can I address the same issues that Mr. Robbins and——

Mr. TORKILDSEN. One moment, Dr. Ture; if I could ask Dr. Aaron how pressed are you for time?

Dr. AARON. I have to leave in 10 minutes.

Mr. TORKILDSEN. If you could defer for a moment, then I have more questions, but I would like to allow someone in the minority to ask one or two questions before he has to depart.

Some of the figures you talked about such as the difference of gain for 4 years reducing the present value, isn't the present value reduced of the asset over that same period of time?

Dr. AARON. The idea is this, in year zero, say I have hundred dollars of capital gain. I hold that asset for 4 years. Relative to being

taxed as the income was earned, I am treated favorably because I don't have to pay that tax until such time as I realize it.

I, therefore, have available a $100 dollar asset on which in the normal course of events some additional income will be earned and I will be able to earn income on what I would have had to pay in taxes had I been taxed currently when the income was accrued. That is the advantage in deferral. The 1986 act went to great lengths to try and reduce tax advantages associated with such deferrals.

Mr. TORKILDSEN. OK.

Just one more general question for you and I will ask Mr. LaFalce if he has questions for you. Take a hypothetical example, when you start measuring people based on income and saying they are in the top 20 percent or whatever it doesn't take into account mobility. For example, a husband and wife own a convenience store, they work all their life, put in sweat equity, one partner passes away or they sell the company to retire on. All their life they would be considered low to moderate income.

That one year they sell the corner grocery, they become part of the wealthiest 20 percent and that is measured as part of income for that year when in reality it is no different than a laborer who has been putting money into a pension fund or Government employee who has been putting money into his or her pension fund. How do you account for that? What percentage of these individuals are there for a one-time only and should not be treated as someone who is doing speculation on annual basis?

Dr. AARON. The numbers I used were averaged over 5 years. Five years is not a lifetime. I freely admit that in extreme cases, such as when a person slowly accumulates sweat equity in a business over 40 years, a 5-year average only gets rid of only part of the bias arising from use of annual data.

I do believe that the problem you are raising is a real one and I believe it is time for Congress to reconsider one of the provisions of the 1986 act. That was the repeal of income averaging.

At that time, the difference between the tax rates was so modest it wasn't considered necessary to retain it.

Since 1986, the top statutory rate went from 28 to 39.6 percent. That is enough of a difference to worry about. I think it is time to bring back income averaging. That would significantly help the household you describe. The statistics I am using, however, already income average.

Mr. TORKILDSEN. Thank you. Because of your time, if I could ask Mr. LaFalce if he has any questions of Dr. Aaron.

Mr. LAFALCE. I pass.

Mr. TORKILDSEN. If any panelists would like to comment on any of the questions I raised, please feel free to do so at this time.

Dr. AARON. Thank you very much and I apologize for the discourtesy of having to leave.

Mr. TORKILDSEN. Thank you for your testimony.

Dr. TURE. If I may, Mr. Chairman, the discussion that went on between Dr. Aaron and Mr. Robbins concerns the question of the nature of the revenue estimates and what they can or cannot show.

Let me state at the outset that I think time series are the last thing in the world one wants to look at in order to find the effect of any change in any provision of the tax law on revenue.

In order to be able to rely on any such information, you would have to have available to you an extremely elaborate, correctly specified, dynamic general equilibrium model formulated in a neoclassical context with lots and lots of variables specified in order to be able to isolate the effect of the one particular thing you were looking at—a tax change—on the flow of tax revenues.

The Joint Tax Committee doesn't do that. OMB doesn't do that. The Treasury doesn't do that. CBO doesn't do that. Mr. Robbins tries to do that and I think you ought to pay very close attention to his work. If it isn't the definitive product, at least it is highly suggestive of the nature of the changes in revenue estimating that the Congress ought to insist on.

Now, having said as much, what happens if you reduce the rate of tax on, say, capital gains? Well, I think everybody agrees there will be increase in realizations of gains—the unlocking effect. That will be significant. I do not want to offer any supposition to you about whether or not in and of itself the unlocking effect would be adequate to offset the effect on revenues of the rate reductions. I do not know. I don't wish to speculate about that.

There is another effect, enormously powerful effect that is generally overlooked. Dr. Aaron didn't even allude to it. That is the effect on the market value of the existing stock of capital assets which clearly will go up as a result of the reduction in the rate of tax on the realization of gains on those assets. It will go up by essentially the capitalization rate that is embodied in the tax rate, and change in the tax rate.

A third effect will be the change in saving, the change in investment, the change in productivity of labor because of the change in the capital-labor ratio, the change in the demand for labor, the change in wage rates, the change in employment, the change in total labor income, the change in total output, that is gross domestic product, and the change not just in revenues produced by the tax treatment of capital gains, but the change in the revenues produced by payroll taxes, income taxes, corporate income taxes, excise taxes, and so on.

Now, when all of those are taken into account, I think you will get an entirely different perspective about the revenue effects of this change.

Let me add one word in response to—sorry that Henry is not here—he relies on what I regard as an antique set of notions about economic behavior. Let me point out in response to his comments about the saving response to a reduction in the rate of tax on saving and the returns on saving, if that response is very, very small notice what that implies. It says the response of consumption to changes in the cost of consumption are very, very small.

Now, you can't have the one without the other. I have never heard any economist of any stripe insist that the elasticity of consumption with respect to price is close to zero.

Thank you.

Mr. TORKILDSEN. Anyone else wish to comment? Mr. Friedman.

Mr. FRIEDMAN. Yes, just a few quick points.

In answer to the question you posed about the hypothetical couple, in a moderate income category all their life and when they retired they had a capital gain that put them for one-time only into a high level of income. The way to address that is not through capital gains preferences. If income averaging would be a more appropriate and fairer way to go if there is a problem of this kind, but not additional capital gains tax preferences.

On the question of what happens to tax revenues when capital gains tax rates are cut or lowered, I am not in a position to dispute in detail the numbers that have been offered by Mr. Robbins, I would note, however—and here I am introducing time series data contrary to what Dr. Ture says we should do—but I think we have to look at history in trying to form the best judgment we can about questions like this.

If you look at our history we have had periods when capital gains rates have been higher and lower. Once you get past the initial period when tax rates change, tax realizations change substantially if you look at a longer period of time. There are fairly clear relationships between tax rates and revenues. When you raise capital gains taxes, tax revenues go up, and when you cut them, they go down.

If you look at the 5-year period, 1981 through 1985, a 20 percent top capital gains rate yielded revenues that averaged $18.4 billion a year over that 5-year period of time. Then came the 1986 Tax Act putting in a 28 percent rate. We went from 20 percent to 28 percent and, lo and behold, during the 5 years 1987 to 1991, capital gains tax revenues averaged $32 billion a year versus $18.4 billion a year in the earlier 5-year period.

It is a complicated relationship. There are a lot of variables and factors, but I think it is nonsense to suggest that if you cut tax rates on capital gains, somehow revenues are not going to fall. They will.

On the question of the impact of capital gains tax rates that Dr. Ture raised, with respect to their impact on savings and investment, even if you fully accept the theoretical underpinning of the argument, the mechanism by which this would have its effect on the economy is through something known as the cost of capital. While I think there is some reason to question whether this mechanism in theory is fully adequate, even if you accept it, I think it is ridiculous to operate in a vacuum on the issue of capital gains. We have a Federal Reserve Board out there. Look what the Fed has done to interest rates in the last year. Look what it has done when it sees an economy growing faster than what it thinks is its growth potential of 2.5 percent a year.

What do you think the Fed would do if this Congress dramatically cut capital gains taxes, and all other sorts of taxes? I think they would raise interest rates even more. I think the effect of that would be to more than swamp the impact in terms of economic stimulus of any sort of tax cut.

Dr. TURE. I think I find a fascinating observation Mr. Friedman just made. What he is saying is clearly the Fed would anticipate that the cut in capital gains tax rates and indexing would have a very powerful expansionary effect on the economy. It would behave I think misguidedly but nevertheless would behave in response to

expansionary forces in the economy. Their assumption would be correct. Their behavior would be wrong.

Mr. FRIEDMAN. They would see a swelling of the Federal deficit and——

Dr. TURE. Piffle.

Mr. ROBBINS. That is what they did in the early 1980's, isn't that right, Norman? Didn't the Fed contract? What happened was that the money supply was constrained considerably and that the prices fell faster than people anticipated.

Dr. TURE. Interest rates plunged.

Mr. ROBBINS. Yes.

Dr. TURE. Employment and gross domestic product and prices of capital assets rose. We are forgetting what happened in 1978, are we not? We had a significant change and enormous increase in capital gains realizations.

Mr. ROBBINS. Even the Treasury acknowledged that.

Mr. BARTLETT [presiding]. Thank you all very much. Let me ask kind of a philosophical question.

Obviously, as tax rates go up, more money moves from the private sector to Governments and if the tax rates are higher on those who make more money than on those who make less money when the Government sends this money back to—and it all gets back some way or other to the private sector, this really amounts to a kind of a redistribution of wealth. Does it not?

Dr. TURE. Yes, sure, it can have a significant effect on the distribution of income claims and uses of them and, therefore, changes in wealth, but can I use your question as a vehicle for responding to the observations made a little earlier, Mr. Bartlett?

Mr. BARTLETT. Yes.

Dr. TURE. There was a lot of discussion in connection with the so-called equity issue about the quintile distribution of the realizers of capital gains of the wealthy and so forth and so on. Notice that all that discussion implied—I emphasize "implied" because it was not explicitly addressed—implied that the population in each of those income quintiles is constant, that they are the same people year in, year out, whether it is yearly or 5-year averages.

What we know for a dead certainty is that the population in each of those income quintiles changes dramatically year in, year out. There is no analytical content in observing that rich people will get the benefits of this, that, or the other tax change by alluding to quintile distributions of a population and their economic activities. That is just silliness.

Mr. TORKILDSEN. Mr. Chairman, request if I could ask Dr. Ture if he could submit something for the record demonstrating mobility between income quintiles. The committee would find it useful.

Dr. TURE. Be happy to.

[The information may be found in the appendix.]

Mr. BARTLETT. Let me ask you another philosophical question. In the physical world, it is kind of a truism that energy or power, whatever you are dealing with, to be effective, must be concentrated; for instance, the tides in which there is an enormous energy, we are able to do almost nothing in capturing that energy because it is not concentrated. Isn't this true also in the economic world? If, in fact, the Government was successful in its attempts

to redistribute wealth and everyone had exactly the same amount of wealth, that that would be very detrimental to the economy and is it not true that concentrations of wealth are essential for providing the venture capital and so forth for creating jobs?

Mr. ROBBINS. Sure. That is precisely what happens when resources are marshalled together for some sort of enterprise. That is the process we are talking about. If we even out everything, the economy will never be able to marshal sufficient resources.

Mr. FRIEDMAN. I wonder if I could offer a contrary perspective on that. The issue in my mind is not whether the role of Government through tax policy is to redistribute income and wealth. The issue is that Government has to raise revenues to pay for legitimate functions that the public through its elected representatives deem appropriate for Government to be performing.

The question is how then should it raise those revenues?

There is a generally accepted concept—at least many people subscribe to it—that the fair way to raise revenues is on the basis of ability to pay. People with higher incomes should be expected to pay not only a higher level, but a higher proportion of their incomes to finance legitimate and necessary functions of Government.

This I think is a sound principle which underlies or should underlie any progressive income taxation system.

What we had in the 1980's was a tremendous unraveling and rolling back of the degree of progressivity in our tax code, at the same time as a lot of other forces were at work in our society and in our economy to redistribute income and wealth away from moderate and lower means individuals and households and toward the top.

Here I must say I disagree strongly with Dr. Ture that there is no value in looking at income quintiles. Certainly there is mobility between income quintiles, but as an analytical tool it has a high degree of validity. The mobility isn't that enormous. I don't think you would find many people going from the poorest quintile to the top 1 percent in any 5-, 10-, 15-, or 20-year period of time. Maybe some do, but most do not.

The issue here really is one of social cohesion. If you don't have a society in which the benefits of economic growth are widely enough shared, number one, you don't have a consumer market. We see that in Mexico today where the workers in Mexico can't afford to buy the products they make.

Second, you don't have enough faith by the citizens of the country in the fairness of their society to keep things on a self-renewing basis. I think anybody who looks at the facts of the American economy over the last 15 years would have to be deeply troubled by the kind of social and economic polarization we have witnessed, where economic growth has not been shared in terms of its benefits through to the bottom 80 percent or so of our income pyramid, where you have stagnating wages for the majority of working people at a time of incredible increase in wealth among the top 1 to 5 percent. This is not a healthy trend.

Mr. BARTLETT. Dr. Ture.

Dr. TURE. I scarcely know where to begin.

So, many issues have just been put on the table in front of you. But let me try some.

There probably is no issue in public finance theory that is more troublesome, more resistant to definitive solution than is what is a fair way to distribute tax burdens. The whole notion of ability to pay has continuously eluded rigorous definition.

Throughout the entire history, no matter what the philosophic complexion of the scholar has been, nobody has ever been able to pin this down in rigorous analytical terms. I would submit to you it is a very, very bad guide for public policy.

Another question about whether or not it is the Government's responsibility to determine how the benefits of economic activity are shared throughout the population. We have a market mechanism that does, despite a huge amount of Government interference, a vastly better job of that than, with all due respect, the Members of Congress can determine. I would strongly urge the Members of Congress not to try to determine that.

The best way to assure that those benefits will be adequately distributed among the population is by, to the best extent you possibly can through public policy, removing impediments to the expansion of employment, investment, saving opportunities. That is what you ought to be looking for rather than to try to determine who should get what out of a given pie.

With respect to this often-repeated notion that real wages have been falling over the last X number of years, that is an arithmetic fallout from the fact that the composition of employment has changed dramatically in the last 20 years. We have moved from being predominantly in terms of employment use a manufacturing society to one in which the most important employment gains in terms of numbers are in services and trade.

Though productivity gains in those trades and those industries have been rising very rapidly along with real wage rates in those industries, the average for the entire work force comes down because of that shift. It is simply not true that in industry after industry real wage rates have fallen. That is a mathematical fallout from the change in composition of labor use.

Mr. BARTLETT. Thank you all very much. We have one more questioner, if Ms. McCarthy would like to ask questions.

Ms. MCCARTHY. No, thank you.

Mr. POSHARD. I would like to ask some questions, Mr. Chairman.

Mr. BARTLETT. Sorry, I didn't see you there. Go ahead.

Mr. POSHARD. I am struggling with the capital gains or indexing to inflation, but I want to ask questions and hopefully better understand this.

I listened to what Dr. Ture said and what Mr. Robbins said with respect to the declining tax rates and so on in the 1980's. I came out here in the middle of the 1980's and one of the things that I learned in my experience out here was that for many years during the 1980's the budgets sent over by the executive branch with the exception of one budget the Congress actually came in under every single one of those budgets. Yes, they did. You go back and look at them, the Congress actually cut the budgets that were sent over here from the President below the level the President had requested.

So, my question is this, during that whole time when we were cutting tax rates when the economy was expanding and the things

that you folks indicated and so on, what caused the incredible increase in the deficit? The deficit to me and the debt we have accumulated is the single greatest problem we have in this Nation today and it tripled during the 1980's and quadrupled now over the past 12 years at a time when we generally saw declining tax rates in this country and expanding economy and so on.

I know defense spending went up very greatly. There were budgets that were projected with certain economic growth rates that never materialized, so we had shortfalls and so on. But whatever we do with respect to capital gains, Dr. Ture, and the other gentleman, Mr. Robbins, Mr. Friedman, I don't want to see the deficit and the debt increase. I guess what I am asking is, what did we do during the 1980's when we seemingly took the right steps to expand the economy but saw the deficit increase.

I don't want to blame the Congress for this because I don't think the Congress was at fault.

I think you got to look at both branches of Government and figure out what went wrong. But how do we avoid that deficit expansion and debt expansion again if we do what you folks are saying we need to do. I am not trying to be adversarial. I am just saying I don't want to see this deficit go up, and I need assurances on this capital gains issue. So, just somebody talk to me about that.

Dr. TURE. I think your concern is extremely well taken and I share it.

If I really believed that Title I of H.R. 9 would have any significant effect on the Federal budget deficits—obviously that depends on a huge number of other actions that the Congress will take—I would not be sitting here with the kinds of observations I have offered you on Title I of H.R. 9.

Let me point out some rudimentary facts. There was 1 tax reduction during the 1980's. That was in 1981. During the out years there were tax increases.

One of my colleagues has put together a little table which I think probably is out of date now because he didn't, hasn't been able to keep it up the last 3 years, but what the table shows is, according to official OMB data, that the amount of additional taxes collected as a result of the tax increases in 1982 and following years significantly exceeds the amount of the tax reduction from the one tax reduction we enacted, that is the one in 1981.

I did some work 2 years ago comparing the budgets that were submitted during the Reagan years—I did not look at the Bush years to be sure—during the Reagan years, and the actual outlays in each of those fiscal years, with the exception of 1-year, actual outlays exceeded Reagan budget requests for outlays sometimes by a small amount, sometimes by significant amounts.

What went into that, so many factors that—first, I don't know them, and second, we don't have time for me to try to recite them if I did know them all.

Let me come back full circle, though. I think your concern is entirely warranted. I think running budget deficits is the most definitive evidence of a fiscally irresponsible Government and I would urge you and all of your colleagues to do everything you can possibly do by supporting an effective balanced budget amendment to preclude this development in the future.

Mr. POSHARD. OK.

Mr. ROBBINS. I think that is right. While I might concede to you that the——

Mr. POSHARD. Before you speak, Mr. Robbins, just the three of you, I want a brief comment on this before my questions end. We have both parties advocating increased military expenditures right now, we have both parties advocating taking social security and Medicare off the table and we have both parties advocating substantial tax breaks to the American people.

I don't see how either party is correct in doing these things and saying we can reach a balanced budget and achieve deficit reduction at the same time.

Now, I throw that in the wash when you speak to this.

Dr. TURE. Let me add the one point—excuse me, Gary——

Mr. ROBBINS. Go ahead.

Dr. TURE. I think we need to do a great deal in the tax law to reformulate it in the interests of a high growth economy and primarily, number one, I think we have to reduce the very widespread, very pervasive tax bias against saving and capital formation.

Whether or not that involves any substantial amount of revenue loss, I hesitate to say. I don't do that kind of work so I am reluctant to offer a firm view on it. I would suggest that if you are convinced that indeed there would be significant revenue losses by constructive reform of the tax system, the appropriate redress is to cut Government spending.

I have gone through some of these exercises about would you cut this, would you cut that, and I find virtually no exceptions. My answer is a ringing affirmative, of course I would cut it. I would ask the question if we didn't have this program, if we weren't spending this money now, would we want to? In almost every case, my answer comes up, of course not. Government has no business trying to do these things. I think that should be your guide.

Mr. POSHARD. The gentleman——

Mr. FRIEDMAN. You have heard us disagree a lot about facts and numbers. It must be very frustrating to be on the receiving end of that. I have to disagree strongly with Dr. Ture about his interpretation of events in the 1980's which I will begin with because I think it is relevant in answering your current question.

My understanding of the numbers is that the 1981 Tax Act did in fact, cumulatively deprive the Treasury of some $2.2 trillion dollars in revenues through 1993, this is approximately, not counting the impact of increased interest outlays, the increase in the national debt from the cumulative string of Federal deficits during these years.

In fact, I think that the string of deficits that occurred in the 1980's can be almost exclusively laid at the doorstep of the unwarranted 1981 Tax Act. if you then bring it up to date and get back to your question, I do think it would be most unwise to consider , once again, simultaneously cutting taxes and raising military spending.

Regarding the balanced balanced budget amendment, I think that is a horribly misguided public policy.

I don't want to get into a long digression here about why I think that, but certainly the budget deficit over time, ought to continue to be responsibly reduced, but not to zero. There is no need for it to be reduced to zero. But the bottom line is that it takes revenues in order to run Government. You can't be cutting taxes and expect the budget deficit to be reduced. It won't happen.

So the reason I mention 1981 is that the current debate has an eerie replay quality to it; we are sitting in the middle of the same kind of debate that occurred back then, and I fear we are about to go off the same cliff. I hope we don't.

Mr. POSHARD. OK, thank you.

Mr. ROBBINS. I think we have had enough of that debate.

Mr. BARTLETT. Thank you. Mr. Friedman, could I summarize your analysis of the tax, 1981 tax consequences as therefore the more we tax the better off we will be as a country?

Mr. FRIEDMAN. No, I didn't mean to suggest that.

Mr. BARTLETT. I hope not. OK. We have one more questioner in this round, Ms. Kelly.

Mrs. KELLY. Thank you. It is interesting hearing the dueling economic theories today and I am going the take pause to think about it and yield my time for questioning back.

Thank you.

Mr. BARTLETT. Thank you very much. Our chairlady has questions.

Chairwoman MEYERS. I would like to thank those who have taken the chair while I have been in and out of here. That is one thing about doing away with proxy voting, it makes us run back and forth an awful lot.

I am a supporter of special treatment for capital gains and I think you will find that we are not going to do anything in the Contract With America that we can't pay for. I might mention that all the contract issues I think show an overall cost of about $150 billion over 5 years. Last year in the Kasich budget, we had cuts of $176 billion over 5 years.

Now, I think we can do all of these things we are talking about and pay for them but that is just a comment on the side. I don't want to leave the impression that we are going to worsen the deficit with anything we do because if that happens, we simply won't do it. I might mention also in welfare and legal and illegal alien programs we are probably spending $500, maybe $400 billion over a period of 5 years.

If we can reduce that by just one-fifth, it goes a long way. In other words, I think the idea that by making tax cuts we are going to worsen the deficit, is just not appropriate. I think we are going to make a lot of changes that have been needed for a very long time.

I would like to ask a question, though, about whether capital gains are for the rich or not. You hear so many different statistics. I think it was Dr. Aaron that said 50 percent of the benefits accrue to 1 percent of the population. We have had some statistics in testimony in the past that 75 percent of capital gains taxes are paid by those with incomes of less than $75,000 and that over half of all taxpayers with capital gains in 1992 had incomes of less than $50,000.

Now, presuming that all of those facts are true, I just can't put them altogether. Will somebody try to put that in perspective for me? Mr. Robbins, maybe you could start out.

Mr. ROBBINS. Let me take a quick whack at that. Those are basically data from the Internal Revenue Service. What you see——

Chairwoman MEYERS. Would you talk into the microphone, please?

Mr. ROBBINS. If you look at the number of folks that have capital gains, what you will find is that roughly half are at incomes of $50,000 or below. They won't have large capital gains, they will have very small capital gains. About 75 percent of the folks with capital gains have incomes below $75,000.

These people have small capital gains.

Using the distribution of the amount of capital gains as an additional weight factor, we can arrive at the statistic that cites the upper 1 percent as collecting 50 percent of the gains.

Mr. FRIEDMAN. Two-thirds.

Mr. ROBBINS. Two-thirds, somewhere in that range.

Chairwoman MEYERS. Wait, this additional weight is the amount of capital gains paid.

Mr. ROBBINS. That is right.

Chairwoman MEYERS. Rather than the number of taxpayers.

Mr. ROBBINS. That is right.

Chairwoman MEYERS. So looking at the amount of capital gains, you are saying that two-thirds of them, I thought Dr. Aaron's figure was half accrued to 1 percent.

Mr. ROBBINS. I don't remember exactly.

Chairwoman MEYERS. He said half.

Mr. ROBBINS. Half to two-thirds, in that range, will accrue to people at the highest income levels.

Chairwoman MEYERS. That is no surprise, is it.

Mr. ROBBINS. That is no surprise. That is how they got to higher incomes as a matter of fact.

Chairwoman MEYERS. They have the most capital gains. But it doesn't mean they are the only ones that benefit.

Mr. ROBBINS. It doesn't mean that capital gains are not important to people with $50,000 in income and below. In fact, gains are extremely important to them.

Chairwoman MEYERS. It may be more important to those with 40 and 50,000 a year incomes when they take their 1,000 a year that they might have in discretionary money and invest it, that might be more important to them than it would to those in the top 1 percent.

Mr. ROBBINS. More importantly, those people in the lower income groups are probably not realizing capital gains each year. They probably realize a gain at a significant time in their life. In other words, they have retired and want to leave the factory they have been working in all their life and move somewhere else. Turns out they have to sell assets and that generates the capital gain. Maybe not a lot, but it generates a capital gain. That is typically how lower income people have capital gains arise.

Chairwoman MEYERS. I had a staff person here who bought a town house that was in terrible shape. They spent 2 years working evenings and weekends and improved it enormously. It was very

costly to begin with, even though it was in perfectly awful shape, just because of the cost of Washington housing, of course.

So, when they sold it, they sold it for $140,000, and they went back to God's country in Kansas and bought about 10 times the house for $120,000.

So, they got caught with that.

Mr. ROBBINS. $20,000 gain.

Chairwoman MEYERS. A rather substantial amount of money; they had to tax at their full income level.

I thought that was a perfect example of people in middle income. They were both working for maybe $35,000, approximately both in that range; $40,000 maybe a year. Yet they were paying substantial capital gains.

Mr. ROBBINS. Yes.

Chairwoman MEYERS. Dr. Ture.

Dr. TURE. Madam Chair, I offered in my testimony and in my oral presentation the observation that I don't think Congress ought to evaluate any kind of proposal on the basis of the income level of the people who are directly affected by it. I don't think the goodness or badness of any tax provision depends on whether or not there are poor people, moderate income people, rich people, who are either adversely or favorably affected. So, one way of getting a different perspective on this is, suppose, contrary to fact—I emphasize "contrary to fact"—that virtually all capital gains were realized by individuals in the first and second quintiles.

Would that make the proposed H.R. 9 Title I proposals better, worse, or would you have the same attitude about them that you now have?

The quality of the proposal does not depend upon who is going to be the beneficiaries. We do not properly tax saving and the returns to saving under the present law. We treat saving as something that is naughty, that we should not undertake. We tax it more heavily than we tax cigarettes.

We should be very much concerned about undoing the existing multiple level tax penalties on saving and investment. It should be a matter of no concern to us whether or not the process of undoing those penalties is primarily going to affect people of this, that or the other income level.

Chairwoman MEYERS. I think this is tremendously interesting and would like to go on. We have another panel to hear from. We have a vote on the floor now. We will stand adjourned for 10 minutes and return for our second panel.

Mr. BARTLETT. I would like to thank you all very much. This wasn't confusing. It was very stimulating and illuminating and I wish we could have another 2 hours with the panel for the discussion.

Thank you all very much.

[Recess].

Chairwoman MEYERS. Our next panel consists of Dr. Richard Rahn of the Small Business Survival Committee; Ms. Jane Gravelle, Senior Specialist in Economic Policy from the Congressional Research Service; and Dr. J.D. Foster, executive director and chief economist of the Tax Foundation.

So, Dr. Rahn, we would like to start with you.

TESTIMONY OF RICHARD RAHN, SMALL BUSINESS SURVIVAL COMMITTEE

Dr. RAHN. Thank you very much, Chairman Meyers. We are most appreciative of your inviting us today.

I am not only a member of the board of the Small Business Survival Committee, but I run a small business that creates joint ventures in Russia, the former Soviet Union and Eastern Europe and I have direct experience in raising capital. I know the problems. I spent many years as both an active academic and association economist and I used to rant and rave against Government spending and taxing and regulation. Yet, I had no idea how bad it was until I started the business a few years ago.

With your permission, I would like to set aside my written remarks and have those inserted in the record and comment on some of the things that were said in the earlier panel rather than just being repetitious about much the same data.

A couple things bothered me with the earlier panel. Henry Aaron made the assertion that there is no impact of capital gains tax changes on the savings rate. Virtually every economist I know of uses capital gains as a tax and savings. If you increase the price of something, you get less of it; if you subsidize something, you get more of it. You almost have to believe the law of supply and demand and the normal supply curve for savings doesn't exist, to buy Dr. Aaron's argument. I have debated it with him before. I look at his argument as utter nonsense contrary to virtually everything that most good economists know.

There was a lot of discussion about redistribution and obviously much of it stems from envy. You listen to the comments of the left and they have very little to do with economic rationality. I think Dr. Ture did well.

But since I have been spending in recent years a lot of time in Eastern Europe and the former Soviet Union. Those who argue for massive redistribution programs have learned nothing from the grand social experiment of the last half of this century. Virtually every type of political and economic system was tried and we have obtained a great deal of empirical evidence about what works and what doesn't. Big tax distribution schemes, whether they are in communist or socialist countries or in basically democratic free market countries, did not work.

I have been around this town for about a quarter of a century now, I hate to admit it but—I look back at all the years I have testified before the Congress and the 1978 capital gains tax, I remember well. At that point I was the operating head of the American Council for Capital Formation. We worked closely with Bill Steiger to reduce the capital gains tax in 1978. Looking at the revenue numbers, I was glad to see Gary Robbins' numbers earlier, you will hear more about how the revenue numbers and the forecasts, how correct the CBO is or how correct the Treasury is or how the numbers could be worse than had been estimated.

But if you look now, there is at least a 20-year period during which a number of us have been making judgments about these numbers and the empirical evidence is in. There is a school of economic thought that has been essentially correct and a school that has been unambiguously wrong over the last 20 years.

Back in 1978, we were faced with huge estimates of revenue losses from the capital gains tax reduction. At the time I estimated they would be much smaller. I was wrong. We actually had big gains. But if you take a look at the estimates made by the classical economists, supply-siders or whatever, versus the Keynesian crowd I think that the empirical evidence is overwhelming that the supply-siders were right and the empiricals essentially have been wrong.

You look at the numbers—and Gary did the numbers over the past few years—but if you go back through the 1980's, 1981 tax changes, the folks on the other side were consistently wrong. Tax revenues have remained relatively constant, almost perfectly constant at about 19 percent of GDP for 20 years. The deficits, have come about because of increases in spending. You have not had massive tax cuts and massive tax losses. It just plain is not true. If you take a look at the numbers you see it is not true.

The problems have been the growth in Government spending and much of it has been nonproductive growth. There is a lot of talk about fairness with capital gains taxes. It is the position of the Small Business Survival Committee that we ought not to have the capital gains tax. The income has already been taxed. The proposal in the Contract With America is a great step forward, but it really doesn't deal with the fundamental problem. The capital gains taxes are paid on income that has been taxed at least once and oftentimes twice or more times and that certainly is not fair.

Much of capital gains taxation is nothing more than paying a tax on inflation. You can have real losses as a result of inflation and you still pay a tax. That is not fair by any definition.

For most capital gains, there is huge risk involved. I am in the progress of organizing joint ventures for investment in Soviet Union and Eastern Europe. These are high risk investments. It is something in line with our national policy, we are trying to bring free market democratic capitalism to these countries. My investors take a huge risk.

They are fully taxed on the capital gains and yet at the same time they can't even deduct fully capital losses. There is a 3,000 a year limitation. That is not fair. It is not right. It is counterproductive. We are hurting the economic transition of these other countries.

We are hurting our own economic growth and much of the rhetoric against comes from envy is nonsense. It is time we became a more adult society and grow out of this kind of an Alice in Wonderland socialism we have been affected with for much of the last 50 years.

I noticed it was not mentioned earlier that most countries of the world don't have a capital gains tax. In fact, every country after adjustment for inflation has a lower capital gains tax than we do. What do the rest of them know that we don't?

It is troubling to see some of the rhetoric around the capital gains tax issue which has little to do with reality.

There is a question that you asked about targeted capital gains taxes, cuts. We are opposed to those. Many people want to target for small business. This is not desirable. They want to target them for other uses. This, again, is Congress and the bureaucrats playing

God. We realize it doesn't work. It hasn't worked in the past. The markets the best to allocate resources. We ought to have an across-the-board reduction where people are treated evenly and fairly as possible.

I would be pleased to answer any of your questions.

[Dr. Rahn's statement may be found in the appendix.]

Chairwoman MEYERS. Thank you very much, Dr. Rahn.

Our next witness is Dr. Jane Gravelle.

TESTIMONY OF JANE GRAVELLE, SENIOR SPECIALIST IN ECONOMIC POLICY, CONGRESSIONAL RESEARCH SERVICE

Dr. GRAVELLE. Thank you very much. I would like to thank you for the invitation to discuss the economic effects of cutting the capital gains tax. I will be mostly talking about the provisions in H.R. 9.

I would like to summarize my testimony and submit the full testimony for the record. I am going to discuss the revenue effects, effects on savings and growth, efficiency issues, equity issues, administrative concerns, and the effects on small businesses in particular. A lot of my testimony will be about the revenue effects.

I think it is a very important issue. I would like to suggest that I believe that the revenue estimates that have been done by the Joint Tax Committee are probably understating certainly in the long run the revenue cost of this provision.

Just to take you back a little bit, there has been a considerable disagreement over the past few years about the revenue consequences of a capital gains tax cut. Both the administration and the Joint Committee on Taxation include in revenue estimates the expectation that individuals will respond to lower capital gains taxes by increasing realizations of capital gains which will raise offsetting revenues.

This projected increase in realizations is substantial and it will lower the static loss estimate for the 50 percent exclusion by over 60 percent in the 5-year budget window.

Empirical research on the realizations response has yielded wide estimates and in studies examining realizations and tax across different tax taxpayers which should yield the permanent response, in extremely large responses. These studies have been criticized as being heavily flawed in part because the estimates they yielded may have reflected responses to temporary rather than permanent tax rates.

I would like to say the Joint Tax Committee chose its estimate of realizations response based on the time-series data that have been discussed in this hearing. They have relied on time series evidence; however, they have not relied on a few years of evidence. They have looked over a long period of time.

I would like to caution you, when you look at this evidence, when you see tables that don't go back before 1985, you see how the fallible they are over time or how they can be strongly affected by changes in the stock market or in recent years' depressions in real estate values. You need to be very cautious about interpreting too much from these numbers.

At any rate, because of the wide variation in estimates based on these various studies I used an alternative approach to assess the

likely size of the realizations response over time. This approach is really based on a very simple observation. Over time, realizations cannot exceed accruals. That is, realizations would equal accruals over a long period of time, year after year, only if individuals sold all assets after holding them for less than a year. You certainly never expect people to do that.

This observation of historical ratios can be used to measure the upper limit of the realizations response and to suggest a likely size of that response. This analysis that I did suggests a much lower permanent realizations response than is used in revenue estimates now.

Basically, it provides a reality check, you might say, on statistical estimates and there are lots of potential problems with statistical estimates. In fact, my analysis suggested that the very large realizations responses found in most of these micro data studies lead to implausible estimates of changes in realizations responses, results far outside the bounds of historical experience and far in excess of accrued gains for tax revisions such as those in the Contract With America.

One problem with these studies is they could not control for timing effects.

Chairwoman MEYERS. Dr. Gravelle, excuse me, define for me "realizations response."

Dr. GRAVELLE. It is just measuring how much more capital gains will be realized because of the capital gains tax being lowered. In other words, if the capital gains tax is lower, you will tend to sell assets more frequently, perhaps sell assets you might have held to death. So, the realizations response measures how much you think realizations will go up because you have cut the capital gains tax. It is a crucial, crucial part of the size of the projected revenue estimates that are done by the Joint Tax Committee.

Chairwoman MEYERS. I presumed that is what you meant but—go on.

Dr. GRAVELLE. Now, the problem with these studies that looked across different taxpayers, with different tax rates to estimate the permanent response was that they could not control for timing effects. These taxpayers had very variable tax rates and if the tax rate varies from one year to the next, it is advantageous for you to realize a lot of gains in the year when your tax rate is low. So, people were concerned that these studies were picking up not permanent responses, but temporary responses.

Indeed, we have a great deal of evidence of that in 1986. In 1986 when we increased future capital gains tax rates and announced it to people, we had an enormous unprecedented surge in realizations and that is why you see that big number for 1986. The tax rate did not change that year; rather the people knew it was going up next year.

It is also one of the reasons that realizations were expected to be lower after that, because people borrowed from their realizations down the road.

There is a recent statistical study that used a new approach to study this response. It looked at the effects across State tax rates, in other words, individuals face different State tax rates on capital

gains, so that variation was used to try to estimate a response, a permanent response.

That study which was just published in September in the American Economic Review, shows results very consistent with my assessment based on my simulation model.

I say this because the effects of this proposal on the deficit are of concern to this committee and of concern to the country and there is, I think, a likelihood that those estimates, if they are not higher in the next few years, will certainly be higher over time.

In addition, the long run cost of the capital gains cuts will be larger in view of the growth in the cost of indexing. Indexing applies only after 1994, so each year there will be more and more inflation and you can see this if you look at the revenue estimates. You can see this dramatic rise in the cost of the indexation provision.

Before turning to the effects on savings and growth, I will also say this revenue loss is not large relative to this economy. Even if we are talking about $50 billion, even $100 or $150 billion over 5 years, relative to the economy that is a $6 trillion or more per year, it is not a large effect. Therefore, it won't have a dramatic effect on savings and the economy.

I would like to turn to the effects of the capital gains tax cut on savings and economic growth. These effects of the capital gains tax are likely to be modest, particularly in the short run. It has long been recognized by economists that in the particular case of saving that the effects of a tax cut or increase in the rate of returns on savings are ambiguous because of offsetting income and substitution effects. This is not nonsense. As I recall, it was first pointed out by Martin Feldstein, a very prominent economist. Therefore, theory does not tell us a capital gains tax cut will increase savings.

Dr. GRAVELLE. I think I said theoretically we couldn't be certain that cutting the capital gains would raise savings and what I did in my testimony is to actually take a more generous, one of the more generous sets of assumptions about the effects of taxes on savings, I used a high elasticity from the literature, that Mike Boskin estimated back in 1978 and some of these empirical studies found a negative relationship which, as I said, is theoretically possible.

I did a calculation over time of the effect on growth and even in these very generous circumstances I found after 5 years the capital gains tax cut in the Contract With America would increase output by 1/20 of 1 percent. This modest effect arises from the small size of the tax change relative to the economy, the evidence of a limited ability of tax policy to influence private saving and the slow pace of the capital accumulation process.

As I said, with less favorable assumptions the effect on economic growth could be negative.

If you heard of models that show large increases in output due to a capital gains tax cut, they do so by the assumption of an infinite savings elasticity and a rapid adjustment process. This is an assumption and not by reference to empirical evidence.

Chairwoman MEYERS. I didn't understand that. Would you explain that once more?

Dr. GRAVELLE. There are studies you heard from Gary Robbins, for example, that indicate a very large effect of a capital gains tax on output. That effect is due to the assumption in that model of an infinite savings elasticity.

Chairwoman MEYERS. That is what I didn't understand.

Dr. GRAVELLE. That means that the capital stock will expand at whatever rate is necessary to hold the after-tax return constant and he assumes that and he also assumes a rapid adjustment period. That is why in the last evidence—last report that I saw, his model predicted that this relatively small tax cut would increase the capital stock by $2.2 trillion over 5 years. Let me tell you that the net savings rate in the economy is a little over $300 billion. We have never seen anything like that in history. This is not an estimate that is taken out of the empirical literature. My estimate is taken from the empirical literature.

If you look overall at the revenue feedback from this growth effect, it comes to about 1 percent of the static revenue loss. So, I say this because I think you shouldn't expect too large an effect from this small tax cut. You should not expect it to do a great deal to offset this revenue cost.

Now, another argument that you may have recently heard—I think you heard it today—is much of the revenue loss will be recouped by increases in the asset values. The calculations are made by assuming a disequilibrium, a distance between the rate of return that the investors are willing to accept and the rate they do get for an infinite period of time. This is not a reasonable projection of what you would expect in the asset market; any effects on assets would be much smaller and transient in nature and they are merely timing. In addition, what you gain in the short run, you lose in the long run as assets return to their prior equilibrium values.

Another argument made for cutting the capital gains tax is that lower rates would increase economic efficiency primarily by reducing barriers to sell.

They could affect the allocation of capital in other ways, however. I am sorry to say the efficiency effects of cutting capital gains taxes are complex, although they seem more likely to occur from cuts in capital gains on corporate stock than they do for real estate.

Also, whether indexation rather than equivalent rate cuts lead to greater economic efficiency is in doubt.

With regard to equity concerns, capital gains are penalized because of the taxation of inflationary gains. But they do benefit due to deferral and nontaxation of gains based on at death. Most of the direct benefits of the capital gains tax cut will accrue to high income individuals. Data presented in 1990 showing the distribution of benefits by income level for the 30 percent exclusion, for example, indicated over half the benefits accrue to the top 1 percent of the population and ¾ accrue to the top 5 percent, because a single capital gain could place that moderate middle-income person into a high-income class. These data are based on 5-year averages. Very little of the capital gain, only about a tenth in this 5-year study, is realized by individuals who have a gain and in only 1 year. So, this problem is present, but it is not a dominant factor in looking at this distributional effect. Finally, with respect to administrative

issues, indexation in particular will complicate administration and compliance.

The capital gains tax change can affect small businesses in several ways. First, interest rates might rise as capital is diverted into equities, although this is offset by increased demand for debt by corporations. These effects are likely to be modest in any case.

In addition, a generally available capital gains provision could undermine the effect of the existing 50 percent exclusion for gains on new stock issues of small firms. That was the provision enacted in 1993.

A small business would benefit directly from the capital gains reduction largely through the sale of business depreciable property, primarily real estate and the sale of land. Whether small businesses should receive special tax subsidies and whether capital gains relief is the best approach to provide the subsidies may be questioned, but there are several ways in which the capital gains tax relief could be more closely targeted to small businesses.

Such approaches might involve expansions of the present small business stock exclusion, providing a lifetime dollar exclusion or providing an averaging provision. However, I must point out that any kind of targeting effort of this nature does tend to considerably increase the administrative complexity of the tax system.

Thank you very much.

[Dr. Gravelle's statement may be found in the appendix.]

Chairwoman MEYERS. Thank you very much, Dr. Gravelle.

Dr. Foster.

TESTIMONY OF J.D. FOSTER, EXECUTIVE DIRECTOR AND CHIEF ECONOMIST, TAX FOUNDATION

Dr. FOSTER. Thank you, Madam Chairman.

I am J.D. Foster, executive director chief economist of the Tax Foundation. I appreciate the opportunity to appear before the committee. The Tax Foundation is a nonpartisan research and public education organization. We have been looking at fiscal policies at all levels of Government since 1937.

I would like to try and put the capital gains tax into perspective focusing on small businesses in particular.

Consider the following short tax history of a small business. Suppose you had the idea for a new product or service, or you saw an opportunity missed by others. Suppose you decided to start your own business and take advantage of this opportunity, all the while knowing the vast majority of small businesses fail in the first couple of years.

Your first task is to raise capital needed to open your doors. As is well-known, the traditional capital markets are generally available only to established businesses, so you talk to your local banker only to learn that banks usually make loans to ongoing businesses. He will make you the loan, however, if you can collateralize the entire amount. Being a citizen of limited means, you turn instead to your own savings, and to your family and friends to raise the seed corn that will give your dream a chance.

At this early stage, the only tax likely to affect your business is the capital gains tax. Anyone lending capital, particularly for such a risky venture as a new business, does so with the expectation of

a large return on his or her investment. The capital gains tax diminishes the after-tax value of that return, thereby discouraging the investment.

Suppose you scraped together the capital to rent some space, buy some equipment, pay your workers, and open for business. If you are like most small businesses, your hopes for turning a profit lie somewhere in the future. For now, all you need to worry about is covering your costs, among which are the social security tax, the hospital insurance tax, and the unemployment insurance tax, which you must collect based on your payroll whether you are in the black or deep in the red.

Some time passes and your business turns a profit for the year. Now you get to start worrying about income taxes as your silent partner, the Federal Government, begins to claim its share.

As it turns out, you were right all along—there is an opportunity here, but you need more capital. Still too small for the regular equity markets, you contact known venture capitalists in your area or who are known to be interested in your industry. Fortunately, they are interested in making the investment, but the capital gains tax is still an issue. The risks remain high and so the after-tax return must be high. The capital gains tax raises the required before-tax return, and the capital gains tax continues to stunt your businesses' growth by limiting your ability to attract investors. Moreover, the income tax is really starting to really bite, so you find yourself increasingly spending valuable management time in tax planning to keep your effective tax rate under control.

Opportunities abound and you need more capital yet, but now you are large enough to issue shares on one of the stock exchanges. Once again, however, the capital gains tax is hiking up the returns demanded by investors. The shares you issue don't bring as high a price as you might have hoped because the capital gains tax reduces the after-tax return for your investors.

Many years later, your business is a success, you've had a good career, and you have just met with a group from another business that has made a fair offer to buy your shares in the business. What to do? If you sell the shares, then you will owe an enormous amount of capital gains tax. The alternative is to pass the business along to your son and daughter, but then they will be saddled with a large estate tax liability and the bankers aren't sure the business can withstand such a liability.

The moral of this story is that the capital gains tax is a serious brake on business expansion at every stage. Combined with the estate tax, which also taxes wealth, the capital gains tax is the most important tax a small business must contend with at the start of the business and at the end of the entrepreneur's association with the business.

I think that story is important because in all of these debates about revenue estimating and capital gains and the macro effects on the economy, we sometimes lose sight of the fact that the capital gains tax can have a very important effect on businesses' ability to expand and their ability to attract capital and once again the small business story sometimes gets lost in the grand discussions of economic policy.

Capital gain can arise for many reasons and the implications for investors and tax policy vary case by case. It is important to consider which tax disincentives are being reduced. Capital gains may be due to inflation. Capital gains may be due to corporations retaining earnings due to the scarcity of resources or to an economic windfall.

Capital gains may also arise when an investor takes an extraordinary risk and succeeds. Investors in a small business hope for just such returns to compensate for the high degree of risk inherent in their investments. While any of these sources may appear in a small business investment, clearly the only source that offers the necessary and reasonable potential for achieving the desired rate of return is that due to risk.

Capital gains tax relief intended to benefit small businesses should be sure to reduce the tax liability from accepting risk. That means reducing the tax rate or allowing an exclusion of taxable capital gains. I would like to touch on two issues that have come up today. The first having to do with capital gains indexing.

For most investors investing in a small business, capital gains indexing will probably not offer much relief. I personally strongly favor indexing, but in the case of small businesses it is just not enough because your tax basis is too low—that is what will be adjusted for inflation.

However, there have been a lot of arguments raised against indexing, particularly having to do with the complexity of indexing which are so extreme and so outrageous as to be hyperbole. That is something we need to be very careful about. Capital gains indexing is somewhat marginally more complicated for most taxpayers than a simple exclusion. It is not the daemon of complexity it has been raised to be.

Another issue has to do with the revenue estimates. I think Jane went through an interesting discussion of the main components of any revenue estimate, the first being the realization effect, second, the asset price effect, and third, the growth effect. I may disagree with her on a few points and economists will debate back and forth. You have a chance to listen to that debate and I will save you any extension of that debate. But, I would like to point out one thing. When scientists of any sort do estimates of whatever it is they are looking at, they have a certain degree of confidence in what they are looking at. That confidence is based on the data itself, on their experience, and so forth. There is a statistical measure of that confidence.

In the estimates that the Joint Tax Committee has done here, our statistical confidence in these numbers is near zero. The actual receipts from a capital gains reduction could be far worse or could be much better than the revenue estimates, as we could raise quite a bit of revenue. We are just not that confident in these numbers; and despite their apparent precision, we are talking about 1/20 of 1 percent of GDP and that is the best we can do perhaps. But the fact is that could just as well be 1 or 2 percent or 1/100 percent of additional GDP growth because of capital gains reduction.

We don't know and you shouldn't be befuddled or confused into thinking there is any degree of precision in these figures. If we were honest in this debate, we would simply say the cost of a cap-

ital gains tax reduction is zero and so cost should not be part of the discussion. We don't have the confidence in the numbers to go beyond that.

Quickly a word about tax fairness. Tax fairness has bedeviled the debate about the efficacy of capital gains tax relief for years. General opposition to taxing capital gains derives from a desire to equalize the distribution of wealth through tax policy.

Obviously, as you pointed out, the wealthy will receive most of the capital gains in pure dollar terms. However, the importance of capital gains and capital gains relief may be far greater for lower and middle-income families than it is for upper-income families because, when the gains arise, they may represent a far greater share of income for the lower and middle income families than it would be for wealthy families.

The capital gains tax represents an explicit choice in economic policy favoring redistributionism at the expense of a stronger economy and more prosperous people. The net result may or may not be a better distribution of the fruits of our economy, but it is a peculiar sense of fairness that would choose such a redistribution when the cost of that policy is that all members of society have less income and less wealth.

While small businesses have much in common with their larger brethren in terms of tax concerns, one matter which distinguishes them is their difficulty under normal circumstances to access the Nation's capital markets.

Another aspect which tends to distinguish small businesses is the prospect of very great returns if the business flourishes and the possibility of losing much more, all of one's investment if the business does not succeed. In each case, properly crafted capital gains tax relief would ease these burdens on small businesses tremendously. Capital gains relief will improve the economy for everyone. The only debate is the magnitude of the effect.

Analyses such as was described earlier by the Ranking Member that suggest capital gains relief is associated with economic downturns may apply on some planet in this galaxy, but it does not apply on this one. Capital gains relief will improve the economy for small businesses and for everyone.

Thank you.

[Dr. Foster's statement may be found in the appendix.]

Chairwoman MEYERS. Thank you very much, Dr. Foster.

I am going the ask a question and then I would like all three of you to answer it, if you could, and you have been so patient today that I hope we won't keep you too much longer.

I would like to start with Dr. Rahn and ask him, but then I would like to have comments from the other two. Incidentally, Jane, you have a doctorate, also?

Dr. GRAVELLE. I am a doctor, also, yes.

Chairwoman MEYERS. So we have Dr. Gravelle with us, too.

Would you comment on or take issue with or agree with anything that has been said by other witnesses today?

I just would like you to kind of comment on each other because I think that will be very profitable for us. Maybe I should have said that before so you could be taking notes but maybe you can remember.

Dr. RAHN. I agree with virtually everything Dr. Ture and Mr. Robbins said. Needless to say, I largely agree with J.D. Foster. I have trouble with Dr. Gravelles' analysis. I want to challenge the committee to look at Gary Robbins' estimates in both the 1986 changes and the changes made in the 1990 Act, and look at some of the estimates on the other side and I think that you begin to have some notion of who has been reliable. Go back again not 6 years, but going back to 1978 with the Steiger bill and I think if you take a look at the estimates made there by the official organizations, they will be most illuminating to you.

We economists can debate models all the time. Part of the problem I have with much of the existing methodology is it treats variables as constants. It is a closed world view. Capital moves in and out of the world—of the United States, and around the world.

If you have zero capital gains taxes in other countries, you make those markets relatively more attractive. It is no great trick to defer income once it is outside the United States and you can do it legally. It is also going to be increasingly possible to do things illegally. This is something I think the Congress needs to be concerned with. I am certainly not in favor of a police state.

The older I get, the more libertarian my tendencies become. But as we move into the age of electronic money and now with digital cash with individual codes it will be quite possible within probably this year and within the next 2 or 3 years certainly for people once they move money outside the United States to have in a anonymous way around the world.

What does that mean in terms of tax policy? We have two ways we can go. We can become an oppressive police state and try to track it all. That won't work. The technology is moving faster than the people at the IRS could ever keep up with. Or we can move to a tax system that depends far less on the income tax and relies on value-added-taxes, with fewer collection points, or other taxes on consumption, because it is going to be very possible and very easy for people who want to evade taxes on capital to evade them if they are willing to invest outside the United States. So, you are going to have this hemorrhage of capital and one way of combating it is to start reduce the onerous tax provisions in this country because many people are quite willing to pay taxes except if they believe the tax is too onerous or too unfair.

Chairwoman MEYERS. Thank you, Dr. Rahn.

Dr. Gravelle.

Dr. GRAVELLE. It is hard to know where to start. Let me say something that I think is very important for this committee to think about and I think for the Congress and I think also it is something shared by a lot of economists and this is the concern about the deficit.

I have said that it is not certain that raising the rate of return or cutting capital gains or any taxes on capital will increase the savings rate. The evidence does not indicate necessarily that it will, but we can be fairly sure that reducing the deficit will translate into increased savings.

So, I think that is very important to think about and also I think we—we are always making policy on the basis of uncertainty. I certainly wouldn't bet the ranch on estimating capital gains responses.

I do believe that the kind of long run reality checks I did are very important research and very revealing, but if you underestimate the cost of a capital gains cut, you increase the deficit. If you overestimate maybe you don't increase it as much.

In terms of the riskiness of what you do to the capital stock, I just think you should be very cautious about accepting evidence that suggests to you that this capital gains tax cut or other proposals in the Contract With America are not going to cost revenue. I think most of them are.

Chairwoman MEYERS. I think we have been very open about the fact that the capital gains tax when we costed it out, costed out the contract that was the second most costly provision. The first was the $500 per child tax credit which we scored I think as $107 billion over 5 years. This one was $70 billion over 7 years, the capital gains was about $70 billion over 5 years.

Dr. GRAVELLE. Even if you look at the time pattern of the revenue estimates now, you will find that they are growing rapidly, the second 5 years is much more costly than the first 5 years. I think that is something real. I don't think it is something that is an artifact of extreme analysis.

I also think—in economics there are many things we don't know very well, but there are things we do know and we know the rate of capital accumulation as a process is very, very slow. The savings rating right now is probably only about 2 percent of the capital stock.

So, even large changes in the short run in the savings rate are not going to do very much to the capital stock and they are not going to do much to output. It is hard for me to imagine any kind of change that is going to have a substantial increase in output from increasing savings in the short run. Maybe in the long run, it will. But it is very hard to imagine that.

So, when J.D. suggests there—maybe it is 2 or 3 percent, maybe 1 percent, I think that is outside the range of what anybody could reasonably expect.

The other thing I want to mention about statistics is I am very skeptical of a lot of statistical estimates, but I am more skeptical of numbers that give you realizations over 7 or 8 years when there have been enormous other changes in the economy like changes in the asset values of the stock market. 1985 was a very hot period after a lot of growth in the stock market and growth in real estate.

I am skeptical of people giving you these numbers and asking you to draw conclusions from those numbers. At least I learned in graduate school that you should never draw conclusions from a few years. You should look at a lot of years and these time series studies looked at all the years there are.

The other studies have tried to look at as many observations as possible. So, I just don't think you can draw very many conclusions from the sort of experience of 1986 or the experience in 1981. I would urge you to be cautious and skeptical about doing that.

Chairwoman MEYERS. All right. Dr. Foster.

Dr. FOSTER. Just a couple things. First, the way I see the capital gains issue is that it is caught in the nexus between the social policy and economic policy. The social policy being how do we redis-

tribute wealth in this country, and the economic policy how do we encourage economic growth and wealth creation.

That is what makes it so difficult we have to try and estimate the costs in terms of lost economic growth, and of course, as economists we can't agree on what the magnitudes are, so we can't give you a fair price for what that social policy really costs in terms of loss economic growth.

Getting back to what Jane was talking about, there are a lot of things we know something about and a lot we don't know much about. My argument was not that economic growth would be 2 percent of GDP if capital gains relief passes, but we just don't know what it will be. Because we really don't have much confidence in these revenue estimates, statistically we ought to say the cost is zero and go to the fundamental issue of what the social policy is versus the economic policy going to be and we ought not get too wound up in these revenue estimates.

Another thing that is very important to keep in mind, as Dr. Rahn pointed out, is that we have a tremendously involved and integrated international capital market. In the United States, we are at the very center of that market. There is no country in the world where capital flows more easily than in the United States. That is very important to this debate because we look at capital gains relief in terms of its effect on savings and investment. We ask, if we lower the capital gains tax will savings be encouraged, and we debate that amount. We ask, if we lower the tax how much will investment be encouraged and what will the effect be. Because in an integrated international market, we can disconnect the savings questions from the investment question.

If we encourage $2 billion to come in, and there is capital formation of $10 billion, the international capital markets, though not perfect, pretty much allow us to invest the extra $8 billion, if my math is right. That is a very important thing to keep in mind.

This separation of domestic investment from domestic saving is something Dr. Aaron really ignores, which is why Dr. Ture called Dr. Aaron's model antique. It does not allow for the international capital flows, does not allow for the idea that you could increase investment by more than you increase national savings in this country.

The last thing I would mention is something very basic and it goes not just to the capital gains debate, but to virtually every debate we have on tax policy. Taxes most immediately have effects on prices. It is hard to remember all the time how important pricing can be to what goes on in our economy. We think, what is a small reduction in tax going to do, whether it is a gasoline tax or a cigarette tax. It is hard to have an intuitive sense of how powerful that can be.

Fortunately almost every day we have a reminder of how powerful prices are. When you drive to work in the morning and listen to the radio, unless you listen to NPR you are listening to commercials, people advertising reductions in price on their product because they think such a reduction will get you to buy the product.

In the paper today, Safeway has a nice little advertisement directed to the least economically sophisticated, talking about Bounty's Big Roll, one with a coupon for $4.99. They advertise this be-

cause even the least economically sophisticated members in our society understand that prices affect behavior. They see a lower price, they will go to Safeway and buy the product if that is what they are looking for.

Thank you.

Dr. GRAVELLE. Could I just say one more thing, something needs to be cleared up about the international issue here.

Chairwoman MEYERS. Yes.

Dr. GRAVELLE. The capital gains tax does not affect foreigners' taxes when they invest in the United States. Therefore, it would do nothing to induce inflow of investment into the United States.

Dr. RAHN. That is not true. It affects the value of the capital stock.

Chairwoman MEYERS. Say that again.

Dr. RAHN. It affects the value of the capital stock. It most certainly affects foreigners.

Dr. GRAVELLE. Let me restate what I am saying, foreigners do not pay capital gains taxes so when we impose a capital gains tax in the initial first round, their rate of return does not go up and therefore there is no immediate incentive for them to make larger investments in the United States, and people in the United States who pay a capital gains on their investment would pay it on investments—although they have very little—but they would pay it on investments in other parts of the world.

So, this international issue may be very important when you are talking about something like accelerated depreciation, something that affects capital both supplied by foreigners and by the United States, but in this case it is not an important consideration. If anything, if I were putting an open economy into my model, I would have sort of a leakage because of the capital gains tax.

If people bid up stock market prices in the market because they want more stocks because the capital gains tax is going down, that will make those stocks less attractive to foreigners who have to pay more for the same old rate of return. So, I don't see the—maybe you have some process by which capital is attracted to the United States, but I certainly don't see it.

Dr. RAHN. If people anticipate a reduction in capital gains, you anticipate a rise in the stock market which attracts more capital in. A great amount of the money that comes in is also recycled American money, off into nontaxable operations outside the country. Many of the models ignore the whole international sector.

Those of us who are working in the international sector, a good share of my day is thinking about tax consequences for our investors. We spend an incredible amount of time building legal structures to minimize the tax for investors. I look at it as a huge waste of resources. We are involved in this process and it is a total waste.

Look at the amount of time we spend on lawyers and accountants. When we had a tax rate of 70 percent. I used to say if you are smart enough to be in the 70 percent tax bracket, you are smart enough not to pay 70 percent in taxes. You spend it on lawyers and accountants and that is what happens when you keep the capital gains tax too high.

I advise foreign governments. I advise the Russian Government and I chaired the Bulgarian transition team. We try to get these

governments to keep their tax rates low, often without success, so the cost of the bribe is greater than the cost of the tax.

Russia brings in little tax revenue because it is cheaper to bribe the tax people. One way to avoid that is to keep tax rates down. In our country we don't have so much trouble with direct bribes, but we do it indirectly through lawyers and accountants.

Chairwoman MEYERS. Dr. Foster.

Dr. FOSTER. The question of how we attract foreign capital goes back to pricing again. Suppose I have an investment—suppose we have this capital gains relief and we increase the amount of the demand for investment dollars in this country and we don't have enough domestic saving to meet that demand. What is going to happen?

Keep in mind these international capital markets are focused on the differential rates of return as measured as in the fifth digit. Not in tenths, or hundredths, or thousandths, but in the hundreds of thousandths of 1 percent. That is a very small increment in the offered rate of return. They can draw billions of dollars of investment capital from abroad into the United States on that basis.

If we are using more investment dollars than we have savings, the rate of interest, the return offered to foreign investors, will go up ever so slightly and that will be sufficient to bring in literally billions and billions of dollars in investment capital. So, it is all operating through the price mechanism. There isn't any magic to it really.

Mr. BARTLETT. [Presiding] I thank you all very much.

Let me ask you a question that came up because of the comment Dr. Foster made and I invite you all to respond to it. You mentioned, Dr. Foster, the tension between social policy and economic policy. You made the statement that social policy has to do with redistributing wealth.

Why would we want to redistribute wealth?

Dr. FOSTER. Well, that is not an economic question. That is literally a social question. It goes to the notion of who in society we think should get the fruits of our labors.

We have developed over time this notion that there should be a disconnect between what people produce and what they get to keep and that there should be a progressive income tax which is another way of redistributing wealth. It is a social compact, a social decision not one grounded in economics, so as an economist, I am kind of at a loss to provide a good theoretical answer.

Dr. GRAVELLE. I have to say the same thing. I think economists have very little to offer on the issues of what programs we should have to redistribute income, who they should go to, to what extent we should have them. Obviously, as social policy, we have decided as a country that we are going to do some of this redistribution, but as an economist that is your job as representatives of the people to decide those issues and really not something that I can shed a lot of light on.

Dr. RAHN. It seems that our society and virtually all others have decided that the natural distribution of income is not politically acceptable and the people want to dampen that or level it to some extent. Where economists can help out is by showing the least de-

structive ways of doing that and also by explaining the destructive consequence when you do do it.

The evidence of the destruction of high taxes can be seen not only in this country, but around the world. Dr. Jerry Scully recently did a study of looking at the level of Government spending and economic growth and we now know that Government spending is about—substantially above the optimum amount for economic growth.

His research had indicated if Government spending had been down near the optimum that since the 1920's we would have had $30 trillion of additional GDP. I don't know how precisely accurate his numbers are, but the point is we have paid a terrible price but an invisible price in lost income and opportunity for many of our citizens by having excessive Government.

When Government wastes money, it is just as bad any other place wasting money and it penalizes real people, hurts real people and I think the economics profession could do a much better job in pointing out how people are hurt by some of these programs to get a better evaluation of really what we want to do in terms of social policy and putting up reasonable safety nets for people.

Mr. BARTLETT. If it is true that the more a country attempts to redistribute wealth, the more harm they are going to do to their economy and therefore there will be less economic opportunity for everyone in the society, wouldn't it—wouldn't one conclude then that the very people who the Government was trying to help by the redistribution of wealth, they are effectively ultimately hurting by denying them economic opportunities that would be available to them if the Government had not been so aggressive in redistributing wealth?

Dr. RAHN. Like everything, it depends on how far you go. You know, for many years the Swedish economic model was looked to as sort of the bridge between socialism and capitalism and there was great romance about it.

But if you look at the performance of the Swedish economy for the last 15 years, it is dismal and the Swedes are now in deep trouble.

About 10 years ago we did a study, back when I was chief economist through the chamber, looking at economic growth as a function of Government spending and one of the things I found was that the more homogeneous the society, the higher level of Government spending you could have without having strong detrimental effects on economic growth, Scandinavian countries, Sweden, Norway, Finland being the best examples of that. We found that in Switzerland, for instance, which is population-wise close to Sweden, but far less homogeneous, a rather heterogeneous society had to have a much lower level of Government spending to maintain the same degree of economic growth as did Sweden.

I think the problem is when you get to a large diverse heterogeneous society like the U.S., it is harder at the national level to do a great deal of leveling. More can be done at the community level where there is perhaps more cohesion among groups, but there is a lot of area for a lot more study here.

Mr. BARTLETT. I have just one last question and that is that—this was something Dr. Foster said that prompted the question—

you mentioned that taxes affect pricing. What did you mean by that?

Dr. FOSTER. Well, the general idea is that resources of all types are ultimately allocated in our economy by their relative prices and as the price of one thing relative to another goes up, more resources are drawn to it. Taxes create wedges between these relative prices and, therefore, distort the allocation of the resources. That is what I meant by taxes affecting prices. If we impose a payroll tax, for example, a wedge is created between the wage received by the worker and the wage inclusive of tax paid by the employer.

Mr. BARTLETT. When a company pays tax, to what extent is that tax simply added to the product or service that they are selling?

Dr. FOSTER. That is probably the toughest question that we have to deal with. It goes to the incidence of a tax on a business and, in general, there is no single answer. The tax on a business can be carried by either the owners of the business, that is capital, it can be transferred to the workers of the business or it can be passed forward to the products. It depends on the market.

Capital, labor and the products and services it sells are all affected so it will vary in each case. I think right now—Jane probably knows better than I—but the Congressional Budget Office presumes I believe that 50 percent of a tax on a business is paid by the owners of the business, and 50 percent by labor and that none of it is passed forward in terms of higher prices.

Mr. BARTLETT. Do you believe that?

Dr. FOSTER. I think that is probably a reasonable approximation. It depends on the market. For example, if I am General Motors and I have to bear a tax that is unique to my industry. I have to find a way to eat most of that tax because if I raise my prices, Toyota will eat my lunch.

On the other hand, if I am in a market where I don't have a lot of foreign competition, for example, I impose a tax on barber shops and it is a local tax, I am probably going to be able to pass that tax on pretty well to my customers because I am not faced with competition. So, it depends on the nature of the market where I am trying to sell my products.

If I can, as a business, my first choice will usually to be to pass the tax forward but the market dictates whether I can do that.

Dr. RAHN. I like J.D.'s point about the international market. It is so poor. To look at the business, it is driven around the world by tax policy. Real transportation costs have fallen and the price of telecommunications worldwide has fallen. It is easier to move capital instantaneously around the world and when tax consideration drive the often form and structure of businesses—you see concentrations of certain types of businesses in certain countries often driven by tax policy. I think you have to be very careful and be very aware of what this will do again internationally with any tax changes you put out.

Mr. BARTLETT. Let me ask Mr. Torkildsen for questions because the hour is late. If there is a moment after his questions, I may ask another one.

Dr. GRAVELLE. I would like to know if you would like me to respond to your last question. I am extremely familiar with this issue.

Mr. BARTLETT. Yes, ma'am.

Dr. GRAVELLE. It is my life work, you might say. The traditional economics suggests the corporate tax is most likely to be borne by capital through a process, the same process that J.D. described. That is the assumption made by the Treasury Department's Office of Tax Analysis and it has been made for some time.

The Joint Tax Committee assumes the tax will be borne by shareholders, they are taking a short run perspective.

So, I think the basic thing that most economists would say who the tax falls on, they would say it falls on expressly capital.

Mr. BARTLETT. In a former life, I was a small businessperson. I was in land development and built houses and when they imposed an impact fee on me or quadrupled the price of a sewer hook-up, I had no alternative but to freeze the wages of the people who worked for me building the houses.

So, the house simply ended up costing more money.

To the extent that the product or the service increases in price as a result of taxes, is not this then a very regressive tax because the poorest of the poor have to buy the products of industry?

Dr. GRAVELLE. If it were passed out in price, it would be a regressive tax. But I have to ask you with your house why didn't you sell it at a higher price before the impact fees, if you could of sold it. That is the problem with the analogy that is passed on in price. If you could sell at higher price, wouldn't it have made sense to do it regardless of whether you had the fee? That is the rationale that people use for believing that taxes, short run, have to be absorbed by stockholders. Maybe this just gave you the idea of selling it.

Mr. BARTLETT. Everybody had the impact fee and we—so we all did the same thing.

Mr. GRAVELLE. That is important. The prices will no doubt rise because of that.

Dr. RAHN. The total number of houses that were sold, they were a fewer number than if you had not had the price increase. So, some people went without these newer, nicer houses you were building.

Mr. BARTLETT. Absolutely. They would buy town houses. If they couldn't do that, they would buy a condominium. They would buy the best house they could with the highest monthly payment that would be approved by the mortgage company.

Mr. Torkildsen.

Mr. TORKILDSEN. Thank you, Mr. Chairman.

I appreciate the patience of the witnesses here. I will try to be brief.

Dr. Gravelle, one statement in your prepared testimony, the evidence—you referred to the evidence of a limited ability of tax policy to influence private savings behavior. Would that run counter to the whole notion of tax avoidance? If tax policy doesn't affect savings behavior or other economic behavior, why would we have this multibillion dollar industry?

Dr. GRAVELLE. We might distinguish between what I will call real behaviors or sham behaviors. To change the amount of our savings, our aggregate savings, is something that is real, and the only way to avoid paying a tax on your capital income is not having a capital income. So, that is a different kind of economic behavior

from, say, recharacterizing your income or engaging in some sort of a process to shelter your income.

The evidence that we base this on, and there are lots of studies of this, is simply that if you look at a long period of time in history, we find the rate of savings does not change very much, in the aggregate, even though the tax rate and the rate of return has changed, and there are reasons to expect that.

But people can take—for example, realizations of capital gains, that is something where you have a lot more flexibility, in terms of the real consequences of their actions, than something like savings, where if I want to save more I have to give up some consumption, whereas realizing and not realizing capital gains is something that may not change those aggregates.

Mr. TORKILDSEN. Dr. Foster, your statement about not being able to affect the international markets, which I would concur with, from my perspective it is increasingly difficult if not impossible to erect barriers to the free flow of capital ideas or services. If that is accurate, would that not—and this is a related subject—would that not make the efforts of the Federal Reserve Bank to inhibit economic growth through raises in the discount rate far less effective than they would have been even 10 years ago when they cannot increase the rate on international capital flows?

Dr. FOSTER. I think the Fed probably feels like it is gradually losing the ability to influence the economy as the U.S. capital markets and the U.S. economy in general integrates further with the global marketplace. It has been argued for many years now, in fact, that the Federal Reserve does not lead but simply follows where the interest rates are going anyway.

If they see interest rates rising, they adjust the interest rates they control up, so there is not too much of a gap. If they see interest rates rising, they will say they are going to raise the Federal funds rate to keep the gap from rising. But, over time, the ability of the Federal Reserve to influence the monetary side of our economy will get increasingly marginalized.

There was a real strong push in that direction in the late 1970's, if you remember the Euro dollar markets that developed what was an explosion of global liquidity, allowing capital to move very, very quickly. There was a real concern at that time in particular that the Fed was going to be completely marginalized. As it turns out, the Third World debt crisis crunched the Euro dollar market pretty well, and it shrank and became less of a problem.

Over time, I think you are right on target, the Fed is going to be less influential.

Dr. RAHN. I just read a paper last week prepared by staff at the IMF where the concern was, as we go to the electronic money, and new smart cards that the central banks of the world will increasingly lose control over money, particularly the disappearance of, diminution of paper money. They will also lose the seigniorage, which is a source of much of their profit, which is another area of concern.

Dr. GRAVELLE. Can I just elaborate on that for a moment, to straighten out something in the question you are asking. Economics very clearly says—economic theory very clearly says that the power of monetary policy to affect the economy relative to fiscal

policy is strengthened by this international capital flow. The reason is that when the Fed tries to change the interest rate, you are right, it is not ultimately very successful in doing so because capital will flow in and out.

That is what gives monetary policy the power to affect aggregate income in the economy. In an open economy, flexible exchange rates, the policy that loses its power is fiscal policy. You then are not very successful in changing economy with fiscal policy, because the interest rates effects will offset.

I just want to make sure, when you say you can't affect the interest rate that doesn't mean that you can't affect aggregate demand in the economy. It is only because that interest rate is exogenous, because of the flow of capital, that you have the power of monetary policy, that you don't have with fiscal policy. I just wanted a little textbook straightening out.

Mr. TORKILDSEN. My concern is that the Fed is attempting to exert more influence than it has right now on the international economy.

Dr. GRAVELLE. It is the arbiter of short-run stabilization in a small, open economy. This is very standard textbook economics. So, it is powerful, even though the interest rate—because of the reactions to that interest rate policy eventually prevent the interest rate from changing very much.

Mr. TORKILDSEN. Fair enough. Just in closing, a comment, while we talk about taxing capital gains, in reality we are not taxing capital gains, we are taxing the individual who claims a capital gain. Because that individual is free in extreme circumstances to even change his or her nationality, again, that makes it more and more difficult for us to base policy on assumed actions of individuals.

The people who have the least options are those who are the smallest investors or those people with the smallest dollar value of capital gains. The ones who have phenomenally large capital gains, as was indicated, can hire a bevy full of accountants and attorneys to find some way to at least reduce if not eliminate what they pay. I think that needs to be part of the record whenever we are debating any changes in tax policy.

But I thank you for your testimony. It is most informative.

I yield back my time.

Mr. BARTLETT. Thank you.

We have another vote call. I just want to thank the panel for your very interesting presentations and your lively discussion.

The fact that there was not unanimity is great. It makes the discussion both interesting and educational for us.

Thank you all very, very much for a thoughtful presentation.

[Whereupon, at 5:10 p.m., the committee adjourned, subject to the call of the chair.]

STATEMENT OF CONGRESSWOMAN EVA M. CLAYTON
BEFORE THE COMMITTEE ON SMALL BUSINESS
UNITED STATES HOUSE OF REPRESENTATIVES
"TAX — CAPITAL GAINS"
Wednesday, February 22, 1995

Madame Chairwoman, I must confess that I bring a certain prejudgment to this hearing. It has greatly concerned me that some have suggested that the discussion on raising the minimum wage and thus raising many American families out of poverty should be tied to this discussion to cut the capital gains tax and index it for inflation. Such an approach, in my estimation, puts the interests of a few monied people above the interests of the rest of America.

I believe that all will agree that the direct beneficiaries of a cut in the capital gains tax are those individuals who rank among the top three percent in earnings. And, while the proponents of this proposal argue strongly that a cut in the capital gains tax will spur economic growth and, thereby, benefit many more incidentally, there are at least an equal number of thoughtful economists who say that it is more likely to stunt growth rather than spur growth. That is because the revenue foregone from the Federal Treasury as a result of the tax cut would result in reduced resources, less economic stimulus and slower growth. Estimates, by reliable sources, including the Department of the Treasury, place the revenue losses at $61 billion for the first five years.

I am further troubled by the fact that, while proponents of this measure want to deny a ninety cents increase in wages, over a two year period, to the bottom twenty percent of income earners in America, unless we enact this capital gains tax cut, they also ignore the fact that unemployment has increased the last two times we cut the capital gains tax in 1978 and 1981. On the other hand, more jobs were created when we raised the capital gains tax in 1976 and 1986. In short, Madame Chairwoman, there is strong evidence that a cut in the capital gains tax will help the few while hurting the many.

Indeed, this tax proposal is very similar to proposals we heard during the decade of the 1980's. It was during that period that we witnessed the ballooning of our budget deficit to more than $4 trillion. We witnessed the collapse of the savings and loan industry. And, we witnessed an increase in the gap between those with money and those without. We must avoid wedding ourselves to the disproved policies of the past. Long term, sustained investment that includes the many, will serve us far better than short-term, short-lived ventures that benefit only a few.

Madame Chairwoman, I believe Government should serve to help everyone and hurt no one. We are in the midst of a very difficult economic struggle, a struggle that challenges many of our beliefs and views. How we respond in these difficult times will shape and

mold this Nation for years and years to come. In good times, I would not likely be so readily a critic of a cut in the capital gains tax. In good times, I would generally support tax cuts of various kinds. But, these are not good times. These are tough times, and we must make tough choices. A cut in the capital gains tax and the resulting revenue transfer to less than three percent of the population could mean that certain educational programs will not be funded, that energy assistance funds will be lost, that rapid transportation subsidies will be sacrificed, that health care programs will be retrenched, and that needed nutrition programs for our seniors and our young will be trimmed back. Those are not difficult choices for me. In my estimation, the wealthiest Americans are in a better position to sustain themselves during this period in history than most others are.

A cut in the capital gains tax, if it is to help spur economic growth, assumes that those with money will invest in the economy. That assumption may not be well placed. We now have the largest balance of trade deficit in the history of this Nation. Much of that can be attributed to the flight of capital from America to more fertile investment opportunities in foreign markets. Any genuine consideration of a cut in the capital gains tax should, in some way, restrict the beneficiaries of that cut from investing the benefits in foreign marketplaces.

Madame Chairwoman, the test of good government is not where it stands and what it does in the good times. The true test is where government stands and what it does in the difficult times. In the end, we will all be judged by the scrupulous eye of history. If we cut the capital gains tax, who do we help, and who do we hurt?

Statement of

HONORABLE JOHN J. LaFALCE
RANKING MINORITY MEMBER

Small Business Committee
February 22, 1995

I appreciate the Chair's willingness to further examine the issue of reducing the capital gains tax and introducing indexation to the capital gains formula as called for in **H.R. 9**, the **Job Creation and Wage Enhancement Act**.

At the first hearing on January 26, I raised concerns about the huge revenue loss to the Treasury--estimated at $183 billion over the first ten years--and the adverse impact this will have on reining in the budget deficit. I also remarked that such a cut would be likely to have an uneven impact on society, giving the preponderance of substantial tax breaks to already wealthy Americans and creating undue hardship for working Americans affected by program budget cuts required to make up for lost revenue. Finally, I questioned the conventional wisdom offered by proponents of the capital gains tax cut that such fiscal action would produce significant savings and investment, thereby inducing economic growth and creating new jobs. I am pleased, therefore, that the Chair scheduled this hearing to focus on these specific issues.

I also recall, Madam Chair, that I voiced my concern that the last panel did not reflect a balance of views about the capital gains tax issue. I had suggested names of experts who might provide such a balance in order that Members might hear the range of positions on this complex issue and be able to have a full discussion among Members and witnesses. I am pleased to note that three of these suggested witnesses are here this afternoon, and I thank you for accommodating my request.

I look forward to hearing from all the witnesses, and I am sure many will address the concerns that I have previously raised. I would, however, like to briefly mention two key issues raised by individuals who have recently testified before the Senate Finance and House Ways and Means Committees. They raise important points to consider in the discussion of capital gains tax cuts.

Robert McIntyre, Director of **Citizens for Tax Justice,** provided data showing a sharp rise in the unemployment rate following both the 1978 and 1981 capital gains tax cuts. Conversely, the jobless rate fell notably after the 1976 and 1986 capital gains tax hikes were enacted.

Michael Schler, past Chair, Tax Section of the New York State Bar Association, noted the enhanced opportunity for tax sheltering under this proposal, and the unfairness and complexity of indexing capital gains. He said that "every experienced tax lawyer who reads the indexing provisions of H.R. 9 immediately dreams up a half dozen ways to 'beat the system' and create a tax shelter that eliminates tax on unrelated income." This statement underscores the concerns of Treasury Department officials who have warned that a capital gains tax cut will result in an increase in tax shelter and tax arbitrage activity.

He further emphasizes that by indexing only assets, as called for in the legislation, and not liabilities, artificial tax deductions can be created with little or no out of pocket expense. Moreover, a fair application of indexing capital gains would have to compensate owners of savings accounts, money market mutual funds, and government bonds for the effects of inflation. The complexity of indexing would reach even to individuals, turning previously simple calculations into "massive calculations"--buying and improving a home, selling the family car, or investing in an IRA.

Thank you, Madam Chair. I look forward to this important discussion this afternoon.

STATEMENT OF JAN MEYERS, CHAIR
HEARING BEFORE THE
COMMITTEE ON SMALL BUSINESS
"CAPITAL GAINS TAX POLICY AND SMALL BUSINESS"
U.S. HOUSE OF REPRESENTATIVES
FEBRUARY 22, 1995

The Committee will come to order.

Today the Committee will continue its examination of the capital gains tax reduction provisions contained in the Contract with America. As the members will recall, on January 26th the Committee heard from several small businesses and economic development specialists regarding the need for investment in small business, and how that could be enhanced through some type of special tax treatment for capital gains.

Our hearing today brings several economic experts before the Committee to express their point-of-view on favorable tax treatment of capital gains as a means of stimulating economic activity and investment in small business. I've asked the witnesses to comment on the capital gains tax reduction provisions in H.R. 9, and provide the Committee with their assessment of whether or not reducing the capital gains tax rate would be a cost-effective way to spur investment and economic growth. In addition, I've asked our expert witnesses to expound on whether or not an across-the-board cut in the capital gains tax would stimulate investment in all areas of small business growth, or would a more targeted incentive be needed. Finally, I've asked to witnesses to testify as to their views of a capital gains tax reduction from the perspective of "tax fairness."

I should point out that three of the seven witnesses testifying before the Committee today are appearing at the request of the Ranking Minority Member, Mr. LaFalce. He submitted a list of

several suggested witnesses for a hearing on the capital gains tax, and those appearing today are the witnesses that accepted our invitation.

As I stated at our January hearing on this topic, I strongly support a reduction in the capital gains tax as a way to help stimulate investment in small business, and as a step towards eliminating federal tax policies which penalize savings and investment for the future. I believe some of our witnesses will be providing data to the Committee which supports this view. Others will present opposing information. The purpose of today's hearing is to gather competing data on the capital gains tax so that Members can benefit from a broad range of knowledgeable experts on the projected economic benefit to small business of a capital gains tax reduction.

At this time, I recognize the Ranking Minority Member, Mr. LaFalce for a brief opening statement.

Mr. Chairman:

Thank you for the invitation to testify on the proposed changes in the taxation of realized income from long-term capital gains.[1]

I apologize for this cumbersome description of the subject of today's hearings. But the fact is that most capital gains are not realized in the year in which they are accrued and that roughly half of all gains are never realized at all. This fact means that *the effective rate of tax on capital gains would be less than half the statutory rate on the average, even if all realized income from capital gains were taxed at statutory rates applicable to ordinary income in the year earned*. In fact, of course, the top statutory rate on capital gains, 28 percent, is well below the top brackets of 36 percent and 39.6 percent, in which recipients of most capital gains are taxed on most of their income.

Deferral of tax for four years, the average holding period of realized gains, further reduces effective tax rates by an additional 26 percent (assuming a discount rate of 8 percent). In addition, approximately 30 percent of all equities are held by tax-exempt entities. *Thus, the effective tax rate on income from capital gains on equities for a taxpayer in the top marginal tax bracket is already less than one-fifth of that on ordinary income*.

The purpose of this hearing, therefore, is not to explore whether income from capital gains should be treated more leniently than is income from other sources. That issue has been settled. Capital gains are now enormously favored over other forms of income. *This hearing and the proposed legislation with which it is concerned address whether forgiving two-thirds to four-fifths of the tax that would be applied to other income is insufficient and needs to be increased*.

Three proposals for increasing those concessions are currently under discussion. One proposal would cut the tax rate applicable to income from capital gains by one-half. The second would index capital gains; or, more precisely, it would adjust the basis used in calculating capital gains for inflation between date of acquisition and sale. The third would allow taxpayers to deduct losses on the sale of personal residences. I shall examine each of these changes separately and then consider them together.

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[1] Director of Economic Studies. The views expressed in this statement do not necessarily reflect those of staff members, officers, or trustees of the Brookings Institution.

Cutting Rates

I attach eight graphics that set forth in outline the issues relating to the desirability of cutting tax rates on income from capital gains. I ask that they be attached to my testimony and included in the record.

The first graphic lists the three broad classes of reasons advanced for taxing income from realized capital gains at lower rates than are applied to other income:

- to promote growth,
- to improve fairness, and
- to increase efficiency of resource allocation.

The second graphic explains why the effective tax on income from capital gains on equities averages only about 7 percent and the effective rate on income from capital gains on other assets averages only about 10 percent.

Effects on Growth

The next several graphics address the question of whether cutting the tax rate on income from realized capital gains would increase economic growth. *My conclusion is that such a tax cut is more likely to lower growth than to raise it.*

The third graphic explains a relationship among domestic investment, national saving, and the trade balance that must be kept in mind to understand how cutting tax rates on capital gains can affect economic growth. Domestic investment is identically equal to national saving (which is the difference between private saving and the deficit on government budgets) and net borrowing from abroad (represented by the excess of imports over exports).

The fourth graphic points out that cutting capital gains taxes applies equally to capital gains from assets located abroad and assets located in the United States. Thus, *cutting capital gains taxes does not increase the relative attractiveness of domestic investment.*

The third and fourth graphics together show that lowering tax rates on capital gains can affect gross domestic product only by raising domestic investment, which can occur only if national saving or net borrowing from abroad increases. For reasons I shall come to presently, *a cut in taxes on capital gains taxes is likely to lower, not raise, national saving.*

Furthermore, while an increase in investment financed by foreigners can increase gross *domestic* product, it cannot raise gross *national* product, because the net return to investment financed by foreigners flows abroad. In particular, increases in foreign-financed investment lower returns to domestic savers and raise earnings of workers.

The fifth graphic shows that *cutting capital gains taxes* will, at best, slightly raise U.S. private saving. Based on Michael Boskin's estimates of the responsiveness of private saving to the rate of return, *private saving will rise less than $2 billion annually*. Boskin's estimates of the responsiveness of private saving to the rate of return generate are at the upper end of empirically calculated elasticities. Estimates of the effect on private saving of cuts in capital gains taxes based on other empirical research would suggest smaller increases in private saving or even decreases.

Thus, a cut in tax rates on income from capital gains will increase U.S. national saving only if the change causes government revenues to fall by less than $2 billion annually. The estimates of the Joint Committee on Taxation suggest that rate reductions will lower tax revenues and hence an increase in government dissaving over the first ten years by an average of somewhat more than $10 billion annually, for a drop in national saving of at least $8 billion annually. These estimates do not take into account the effect of narrowing the federal income tax base for state revenues in those states that base state income taxes on the federal tax base. Eventually, the bond-rating services will force states to either raise other taxes or cut government spending. In the short run, however, some additional loss of national saving can be expected through increased state budget deficits or reduced state budget surpluses.

The sixth graphic indicates why sizeable revenue losses are inevitable. If capital gains rates are halved, realizations would have to double to sustain revenues. An increase in realizations is possible in the short run, and both the Treasury and the Joint Tax Committee anticipate a short run increase. That is why the estimated revenue loss in the early years after a rate reduction are so much smaller than revenue losses in later years. *The sixth graphic shows that a sustained increase in realizations sufficient to sustain revenue collections is virtually impossible*. The revenue loss in the second five-year period averages $13 billion to $16 billion annually.

Effects of Cuts on Realizations

Some observers claim that they can infer from historical series on capital gains realizations that cutting capital gains tax rates actually *raises capital gains revenues*. *Such evidence tells essentially nothing about the effects on government revenues of a cut in tax*

rates on income from capital gains. One reason, already stated, is that a brief and unsustainable increase in realizations is likely to occur simply because a tax cut puts realizations of capital gains "on sale." It is the normal and sustainable rate of realizations that determines whether a cut in capital gains rates will raise or lower *capital gains taxes*.

A second, and much more important reason why historical rates of *tax collections on capital gains say nothing whatsoever about the effect of cutting capital gains rates on government revenues is changes in revenues from taxes on capital gains realizations reveal only part of the effects on what really counts -- total federal revenues*.

A cut in taxes on income from capital gains produces three distinct effects.

- The first direct effect is to lower revenues on asset sales that would have occurred even if tax rates had not been cut.

- The second direct effect is to induce additional sales, which tends to raise revenues.

- The third effect is more subtle and complex. Enlarging a wedge between taxes on income from capital gains and taxes on other forms of capital income or on earned income generates incentives for people to convert interest and dividends into capital gains. Companies will face increased incentives to retain earnings, which cause stock values to increase, rather than to pay dividends. Businesses will face increased incentives to pay top management through stock options, which hold the promise of capital gains, rather than through salary. These and countless other devices exist to "recharacterize" ordinary income as capital gains.

To the extent that this process occurs, any increase in tax collections on capital gains comes at the expense of larger cuts in tax collections on ordinary capital and labor income. To that extent, the larger the increase in tax collections on capital gains, the greater the overall revenue loss.

Effects on Investment Demand

The seventh graphic reviews a series of reasons for cutting tax rates on income from capital gains based on the potential for such cuts to encourage investment. I conclude that *there is no reason to think that cutting capital gains taxes would perceptibly improve access to capital of investors with promising ideas*. The underlying points are simple. Most capital

markets are highly efficient. Unless one can show that markets currently deny capital to significant quantities of investment with returns superior to investments that actually secure financing, giving investments that cannot win support from financial markets a still larger advantage than they now enjoy over other investments that now secure financing can only reduce the efficiency with which capital is allocated.

To justify reduced capital gains tax rates, it is necessary, therefore, for advocates to show that current effective rates, already a small fraction of tax rates on ordinary capital and labor income, egregiously deny resources to highly profitable projects and that these misallocations are so large that the net gains from lowering rates still further are sufficient to offset the loss of domestically financed investment that will occur because U.S. national saving will be reduced.

I have listened to debates on capital gains taxes for many years. Not only have I never heard such a justification, I have never heard attempts at making the case that go beyond bald *ex cathedra* assertions without supporting evidence.

Double Taxation

An additional reason advanced for reduced rates is the fact that corporate source income is subject to double taxation. By further reducing the rates on capital gains, it is argued, Congress can partially ameliorate this inequity and inefficiency. This argument has some merit, but not much. *Double taxation exists and should be ended, but cutting capital gains rates is a perfectly awful way to try to do it*.

The problems are several. First, roughly half of capital gains occur in real estate, where partnerships and subchapter S corporation are typical and, hence, double taxation is not an issue. This industry already benefits from the sharply lower effective rate of tax on capital gains. Because income through capital gains is more common in this industry than in most others, current rules already favor real estate investments over equally productive investments in other assets that typically generate income in fully taxable forms.

Second, the principle problem of double taxation concerns dividends, which are fully taxable when received by taxable individuals and businesses, not capital gains on which effective rates already are tiny. Third, *if the problem of double taxation deserves attention, and I believe that it does, then the way to fix that problem is to fix that problem. The Bush administration, in its waning days, put out the most thoughtful and complete study of the problem of double taxation ever seen and showed the way to fixing the problem*.

The last graphic examines the fairness of further reducing effective taxes on capital gains. I recognize that fairness is not a matter on which hard judgments are possible. But a correct understanding of the facts is possible. During the past two decades, the distribution of incomes in the United States has become progressively more unequal, and incomes in the lower third of the income distribution have fallen sharply. Cuts in capital gains taxes disproportionately benefit households in the top 1 percent of the income distribution, the one part of the income distribution that has done quite well over the past two decades. Moreover, *most of the near term revenue loss is in the nature of a windfall, based on asset appreciation that has already occurred. Such revenue loss can do nothing to promote economic growth*. It is simply a gift. I frankly do not understand how anyone can defend the fairness of such a gift at this time.

Indexation

The second major proposed change in the taxation of capital gains would address some of the problems that arise from taxing nominal capital gains. The proposal would adjust the basis used in calculating capital gains for inflation that occurs after 1994. This method will, in general, result in the correct measure of real capital gains, except for the fact that it does not apply during any period over which prices fall. Although deflation has not occurred in many recent years, this peculiar asymmetry raises the possibility that at some time in the future the same taxpayer could file a tax return in which he or she reports inflation-adjusted capital gains held over inflationary periods and inflation-unadjusted gains held over some other deflationary period. This asymmetry makes no sense whatsoever.

In fact, *indexing of capital gains income alone will raise more problems than it solves*. The problem is that *indexing one form of capital income, but not all, inevitably creates opportunities for tax avoidance*. In particular, since interest payments and debt explicitly will *not* be indexed, the indexation of capital gains strengthens incentives to borrow to finance purchase of capital-gains-generating assets. In such cases, the inflation component of interest rates is fully deductible, but the inflation component of capital gains is exempt. In the absence of interest rate adjustments, this option for coining money would be virtually open-ended -- financially riskier than forgery, but legally much safer. Consequently, one would expect real interest rates or prices of indexable assets to rise as a result of indexation.

To the extent that asset prices rise, the reduction in national saving caused by cuts in tax rates on income from capital gains will be enlarged. It is well established that personal consumption rises when household assets increase. One would expect household assets to

increase by approximately the present discounted value of the reduction in taxes from indexation. The Joint Committee on Taxation estimates the revenue loss ten years after indexation takes effect at more than $9 billion and rising steadily as the period after the effective date of the legislation increases. But the revenue loss is rising steadily and may be expected to continue rising for at least another two or three decades.

This revenue loss directly increases the deficit. To the extent that the loss grows, it could induce additional increases in private consumption in anticipation of future tax savings. In any event, *indexation approximately doubles the revenue loss and the associated reduction in national saving attributable to rate cuts, bringing the total loss to approximately $20 billion annually*.

Exactly how large the ultimate revenue loss from indexation will become is hard to estimate, *but I think it is close to the truth to say that indexation will substantially eliminate taxes on portfolios of more than modest size*. The reason is quite simple. Indexation has the effect during inflationary periods of lowering large capital gains, of converting small nominal capital into real losses, and of enlarging real losses. If all gains were taxed as accrued (universal "mark to market") and if other capital income were also indexed, this adjustment would be the correct one to make. But neither of these two conditions is satisfied.

Not only can investors use unindexed debt to finance indexed assets, as noted above, but, in addition, investors can choose which assets to sell and which to retain. By increasing the share of capital gains assets that will show taxable losses, indexation greatly increases the opportunity for investors to match losses and gains, thereby obviating the need for them to realize gains in excess of losses. Owners of small portfolios and some lucky owners of large portfolios containing nothing but big winners may find themselves unable to engage in such "balancing," but indexation greatly increases the scope for this method of tax avoidance.

Let me be clear. I am not simply opposing indexation of capital gains. *I am urging that vigorous efforts be made to index all capital income and that such treatment be granted to any taxpayer who agrees to mark assets to market annually or at some other stipulated frequent interval*. Owners of capital assets who do not wish to mark assets to market would forego indexing.

Capital Losses on Owner-Occupied Housing

Owner-occupied housing is the most tax favored asset under current law. The income from this asset, imputed gross rent, is excluded from the tax base. Owners are nonetheless permitted to deduct two expenses of ownership normally permitted only for income-generating assets, interest expense and property taxes. Capital gains on sale of a principal residence are excluded from tax if the owner purchases another house within two years. In addition, current law excuses the first $125,000 of capital gains on sale of a principal residence for homeowners over age 55 who sell their houses.

The result of all of these concessions is the allocation of an excessive share of the U.S. capital stock to housing and too little to less favored assets. To this list of incentives, some people would add the still further advantage of allowing deduction of capital losses. About the only favorable observation that one can make about this change is that the revenue loss is not very large. From any other standpoint it is deplorable tax legislation, enlarging an incentive to resource misallocation and doing so in a way that helps most those who need help least. As with any deduction, the relief is proportional to tax rates and hence assists most those who are in the highest tax brackets. Furthermore, the limit on capital loss deductions means that losses in excess of $3,000 must be carried over unless one has sufficient capital gains to offset losses on sale of a house.

Rather than enlarge the already excessively generous tax treatment of owner-occupied housing, Congress should be taking steps to curb current advantages by limiting mortgage interest and property tax deductions. I recognize the political obstacles to such changes and therefore suggest limits on these deductions that would affect few people today but that would bite increasingly as prices rise. A limit on mortgage interest deductions to, say, $10,000 in excess of reported capital income would be a good place to begin.

Concluding Comments

In your invitation, Mr. Chairman, you raised three broad questions. Most of my testimony has been devoted to answering the first, concerning the effects of the proposed changes in tax rules applicable to income from realized capital gains on economic growth. I have argued that the effects would be pernicious.

- By reducing national saving, because government revenues would fall more than private saving would increase, the capacity of the U.S. economy to invest from its own resources would be reduced, economic growth would be slowed, and economic welfare reduced.

- Not only would growth be slowed, inequality would be increased.

If you want to reduce growth and increase inequality, you should vote for the proposed cuts in capital gains tax rates, indexing, and liberalized treatment of owner-occupied housing. If you want increased growth and reduced inequality, you should vote against these changes.

Your second question concerns how other countries tax capital gains and how their practices have affected their economies. In general, other countries do a poor job of taxing capital gains. To the extent that their economies resemble our own, my preceding comments respond to how their practices affect their economies.

One point deserves emphasis, however. The United States should determine the personal income tax on capital gains without concern about how the personal income tax systems of other countries operate. The United States asserts world-wide jurisdiction over income of U.S. nationals and residents. Thus, foreign personal income tax rules, however favorable they may be to capital gains, are not relevant to economic incentives facing people subject to U.S. tax rules. To be sure, the fact that the United States taxes capital gains somewhat more heavily than other countries do might lead a few wealthy U.S. nationals to renounce citizenship and take up residence abroad or discourage a few wealthy foreign residents from taking up residence in the United States. I do not believe that this possible distortion rises to a level worthy of legislative notice.

The final question you posed concerns the tax rate at which the Federal government will maximize revenues from taxes on capital gains. To this question, two answers are appropriate.

First, it is the wrong question to ask. *If you want to maximize revenues from capital gains taxes, the most obvious and fertile change would be to impose constructive realization at death – that is, all gains unrealized at the taxpayer's death would be taxed as if realized at market value. This change would not only raise considerable revenue directly, it would also significantly reduce the lock-in effect of capital gains taxes, thereby shortening holding periods.*

It is the wrong question for another reason. The objective of taxation is not to find the rate at which taxes maximize revenue. It is to find the combination of tax rules and rates that produces sufficient revenues to pay for public services and that does so in a way that produces the best possible combination of economic efficiency and fairness. Lowering capital gains tax rates, indexing capital gains income but not other asset income, and widening the advantages accorded owner-occupied housing fail this test miserably.

GRAPHIC 1

Reasons for Cutting Capital Gains Taxes

✔ Growth

-- Increase saving

-- Increase investment demand

-- Increase venture capital

✔ Fairness

-- Offset failure to index

-- Offset double taxation

✔ Efficiency

-- Tax cut that loses no revenue

GRAPHIC 2

What *is* the tax rate on capital gains?

1. The top rate on capital gains is 28 percent.

2. Roughly half of capital gains are never taxed, reducing average effective rate to 14 percent.

3. Deferring gains for 4 years reduces the present value of tax liabilities by 26 percent, at an 8 percent discount rate, lowering the effective rate to 10.3 percent.

4. 30 percent of equities are held by tax exempt entities

5. *Thus, the average effective rate of tax on equity investments is now about*

   7.2 percent,

   one fifth or less of the 36 percent or 39.6 percent rate on ordinary income paid by recipients of most capital gains.

GRAPHIC 3

Savings and Investment

$$I_D = S_P - D + (M - X)$$

I_D = Domestic Investment

S_P = Private Saving

D = Government Deficit

M = Imports

X = Exports

In words: domestic invesment is <u>identical</u> to the sum of national saving (S_P-D) and the trade deficit (M - X).

GRAPHIC 4

Investment Demand

Reduction in tax on capital gains would apply to gains earned abroad, as well as to gains originating in the United States.

☛ *Therefore:*

A cut in taxes on capital gains will not change the proportion of U.S. financed investment located in the UnitedStates

☛ *Therefore:*

A cut in taxes on capital gains can increase investment in the United States *only if* it increases U.S. saving (S_P - D)

GRAPHIC 5

Effects on Private Saving

Assumptions

-- One-third of return of total asset return is capital gains

-- Tax rate cut from 28 percent to 14 percent

-- Current effective tax rate on capital gains is about 7.2 percent

-- Saving elasticity = 0.4 (Boskin, 1978)

Implication

Private saving will rise by less than <u>$2 billion</u> per year

GRAPHIC 6

Effects on the Deficit

✔ Revenue falls if proportionate cut in taxes is *larger* than proportionate increase in realizations

✔ Revenue rises if proportionate cut in taxes is *smaller* than proportionate increase in realizations

☛ *Therefore*: If tax rate is halved, realizations must *at least* double or revenues will fall

☛ *Fact:* Currently half of gains are never realized

Calculation: If realizations double, the proportion of gains that is realized would have to rise from ***50 percent*** to ***95 percent***[1]

Conclusion: Cutting capital gains rates will reduce income tax collections

[1]Based on formula reported in Alan J. Auerbach, "Capital Gains Taxation and Tax Reform, *National Tax Journal*, vol. 42 (September 1989), pp. 391-401. Annual realizations averaged 3.3 percent of assets from 1978 through 1987. Assumes that 23 percent of assets ever realized are realized in a given year, that the annual gain averages 10 percent

GRAPHIC 7

Access to Capital Markets

1. Existing Corporations
   Currently have ready access to capital

2. Venture Capital
   -- Only 12 percent of venture capital is from taxable sources, and venture capital represents about 1 percent of total net investment
   -- Given effective tax rate oncapital gains of less than 10 percent, cutting the rate in half would increase a profit of, say, $100 to, perhaps, $105

3. Inflation
   -- Solution is indexation (note: requires indexation of *all* capital income, a desirable reform)
   -- A paradox: when part of gains are inflation-generated, the proportion of gain subject to tax should *rise* with the holding period

4. Double Taxation
   -- The solution is integration
   -- Capital gains cut will aggravate the problem because the biggest gainers will be real estate, where no double-taxation problem exists

GRAPHIC 8

Equity

Horizontal equity

Investors equalize expected returns, *given existing tax rules*

☞ Therefore, inequity occurs only when tax rules *change*

Vertical Equity

Judgments are *entirely subjective*

Facts:

-- Top 1 percent of income recipients would receive more than 50 percent of benefits

-- Bottom 80 percent of income recipients would receive approximately 10 percent of benefits

-- Averaging income over many years reduces this disparity only slightly

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Statement of

J.D. Foster, Ph.D.
Executive Director and Chief Economist

Tax Foundation

on

Capital Gains Taxation and Small Businesses

February 22, 1995

Mr. Chairman and Members of the Committee, my name is J.D. Foster and I am the Executive Director and Chief Economist of the Tax Foundation. It is an honor for me to appear before your Committee today on behalf of the Tax Foundation to discuss the federal capital gains tax and its consequences for America's small businesses.

The Tax Foundation is a non-profit, non-partisan research and public education organization that has been monitoring fiscal policy at all levels of government since 1937. We have approximately 600 contributors, consisting of large and small corporate and non-corporate businesses, charitable foundations, and individuals. Our contributors cover practically every region of the country and every industry category.

I would like to emphasize to the Committee that the Tax Foundation is not a "grass-roots" organization, a trade association, or a lobbying organization. We do not take positions on specific legislation or legislative proposals. Our goal is to explain as precisely and clearly as we can the current state of fiscal policy and the consequences of particular legislation in the light of the tax principles delineated below, so that you, the policymakers, may make informed decisions.

When it was established in the late 1930s, the Tax Foundation's founding fathers set out certain principles of taxation which the Tax Foundation would promote and which would guide our analysis of tax proposals. According to these principles, a good tax system should:

- o Be as simple as possible -- complexity makes accurate tax compliance needlessly expensive and diminishes the public's willingness to comply with the law;
- o Not be retroactive -- taxpayers must have confidence in the law as it exists entering into a transaction;
- o Raise revenue, not micromanage the economy with subsidies and penalties;
- o Not be continually rewritten -- frequent change lessens citizen understanding of the tax code and complicates long-term economic planning; and,
- o Be implemented recognizing the competitive nature of the world economy.

I commend the Committee for holding this hearing on capital gains taxation and small businesses. A great deal has been written and said about the effects of the capital gains tax and your efforts to work through this body of work is certainly no small task.

A Short Tax History of a Small Business

To put the capital gains tax into perspective, consider the following short tax history of a small business. Suppose you had an idea for a new product or service, or suppose you saw a market opportunity missed by others. And suppose you decided to start your own business to take advantage of this opportunity, all the while knowing that the vast majority of small businesses fail within the first couple of years.

Your first task is to raise the capital needed to open your doors. As is well known, the traditional capital markets are generally available only to established businesses, so you talk to your local banker only to learn that banks usually make loans to on-going businesses. He will make you the loan, however, if you can collateralize the entire amount. Being a citizen of limited means you turn instead to your own savings, and to your family and friends to raise the seed corn that will give your dream a chance.

At this early stage, the only tax likely to affect your business is the capital gains tax. Anyone lending capital, particularly for such a risky venture as a new business, does so with the expectation of a large return on his or her investment. The capital gains tax diminishes the after-tax value of that return, thereby discouraging the investment.

Suppose you scraped together the capital to rent some space, buy some equipment, pay your workers, and open for business. If you are like most small businesses, your hopes for turning a profit lie somewhere in the future. For now, all you need to worry about is covering your costs, among which are the Social Security tax, the Hospital Insurance tax, and the Unemployment Insurance tax which you must collect based on your payroll whether you are in the black or deep in the red.

Some time passes and your business turns a profit for the year. Now you get to start worrying about income taxes as your silent partner, the federal government, begins to claim its share.

As it turns out, you were right all along--there is a opportunity here, but you need more capital. Still too small for the regular equity markets, you contact known venture capitalists in your area or who are known to be interested in your industry. Fortunately, they are interested in making the investment, but the capital gains tax is still an issue. The risks remain high and so the after-tax return must be high. The capital gains tax raises the before-tax return your new investors are demanding and the control they insist on exercising in order to make the capital infusion.

Fortunately, all goes well, the venture capitalists make the investment, your business grows and profits continue to climb handsomely. But payroll taxes continue to drain the cash flow you need to meet your investors' demands, the income tax continues to shrink your after-tax resources, and the capital gains tax continues to stunt your business's growth by limiting your ability at attract investors. Moreover, the income tax is really starting to bite, so you find yourself increasingly spending valuable management time in tax planning to keep your effective tax rate under control.

Opportunities abound and you need more capital yet, but now you are large enough to issue shares on one of the stock exchanges. once again, however, the capital gains tax is hiking up the returns demanded by investors. The shares you issue don't bring as high a price as you might have hoped because the capital gains tax reduces the after-tax return of your investors.

Many years later your business is a success, you've had a good career, and you have just met with a group from another business that has made a fair offer to buy your shares in the business. What to do? If you sell the shares, then you will owe an enormous amount of capital gains tax. The alternative is to pass the business along to your son and daughter, but then they will be saddled with a large estate tax liability and the bankers aren't sure the business can withstand such a liability.

The moral of this story is that the capital gains tax is a serious brake on business expansion at every stage. Combined with the estate tax, which also taxes wealth, the capital gains tax is the most important tax a small business must contend with at the start of the business and at the end of the entrepreneur's association with the business.

The Capital Gains Tax and Incentives

Capital is the net total of what individuals have saved over their lifetimes. Individuals invest, first, to preserve the value of their capital against inflation and, second, to increase the value of their capital. Investing means purchasing an asset. An asset's price is determined by the after-tax income stream it is expected to generate, discounted to reflect expected inflation, a minimal required rate of return, and the degree of uncertainty perceived to be associated with the investment. In general, the asset price may vary, thereby producing a capital gain or loss to the asset's owner, either through a change in the expected income stream, a change in the tax treatment of the investment, or a change in the perception of the underlying uncertainty associated with either the income or the tax treatment.

At any time individuals have a relatively risk-free investment alternative in the form of federal securities. These securities are risk-free in the sense that both the principal and the stated interest earnings are assured. In a no-tax world, the interest earned on federal securities would be the product of the rate of inflation expected over the holding period of the security and an after-inflation (real) rate of interest which is established by the market as the minimum required to entice investors to hold the securities. Even federal securities, therefore, carry the risk that the inflation rate or the market's required real rate of return will increase and offer the potential of unexpected returns should either of those rates decline.

Virtually all other investments carry a degree of risk exceeding that of federal securities. To entice investors to make these other investments, the expected rate of return must exceed that for federal securities. Investors establish the return they will require on a more risky investment by considering the inflation expected over the period, the minimum rate of return, and the degree of uncertainty about the overall investment. These considerations establish a rate of return required by the market on each investment.

When taxes are imposed, the required return on an investment increases sufficiently to allow the investor to receive the after-tax required rate of return. The difference between the pre-tax and the after-tax returns is called the tax wedge. Higher taxes on investment income raise the tax wedge and reduce the range of investments capable of yielding a sufficient rate of return. Therefore, changes in the taxation of capital income alter the capital stock the economy can profitably employ, which, in turn, alters the rate of investment as the actual capital stock is increased or decreased to match the desired capital stock.

The capital gains tax is peculiar in many respects when compared to other taxes on capital income, such as the taxation of corporate income, or of dividends and interest income. The capital gains tax may be deferred in some instances, such as when the taxpayer sells a home and rolls any capital gain into the purchase of a second home. The recognition of a capital gain arising in one tax year may also be deferred until some subsequent year when the underlying asset is actually sold. Despite these and other differences, however, the effect of the capital gains tax on investment has one important feature in common with other taxes on investment income--it raises the tax wedge and reduces the desired stock of capital nationally.

Anatomy of a Capital Gain

A capital gain may arise for many reasons. The implications for investors and for tax policy vary case-by-case, so it is important when considering capital gains tax relief to understand which tax disincentives are being abated.

Inflation

Possibly the most dominant source of capital gains is the rise in asset prices, along with all other prices, due to inflation. Unlike all the other sources of capital gain described below, however, to the extent an asset price rises along with the general price level, the asset holder has reaped no real economic gain. The absence of any real gain when assets appreciate due to inflation is the source of the widespread popular appeal for capital gains indexing.

Corporate Retained Earnings

Corporations have long found that internal financing through retained earnings can be very cost-effective. These earnings, which are the residual after all expenses have been paid, dividends are distributed, and previously issued debt or equity is redeemed, are frequently re-invested in the company, thereby sustaining the current price of the company's shares.

Suppose a company had 100,000 shares outstanding that were trading at $100 per share at the beginning of the year. Suppose over the course of the year that the company had after-tax earnings of $12 per share. If the tax rate on dividends and capital gains were 33 percent, then over the course of the year the share prices would tend to rise to about $108 per share. If the company declares a dividend distribution of $12 per share, then on a per share basis the shareholders will receive the $12 distribution, pay tax of $4, and watch their share prices return to $100, for a net 8 percent return. Alternatively, if at the end of the year the company decides to retain these $12 per share earnings for re-investment, then the share prices will rise to $112. Shareholders will have received a 12 percent pre-tax return for the year in the form of unrealized capital gains which, when realized, will yield an 8 percent after-tax return.

Capital Gains and Scarcity

Natural resource commodities such as land, petroleum, gold, etc., also provide capital gains for their owners because of their scarcity. At any point in time, there is a fixed supply of these commodities available to the market. Over time, as natural resources are depleted, unless demand falls due to other forces the prices of these resources naturally rise to reflect this growing scarcity. As these prices rise they produce capital gains for their owners.

Returns to Risk

All investments carry some element of risk, however the nature and degree of risk can vary tremendously from investment to investment. Consider an asset that will either yield nothing or will return exactly $10,000 in ten years, and suppose over the course of time that the investor will be able to gauge with increasing certainty the probability of the $10,000 payoff. Whatever the probabilities of the payoff at the beginning, the asset will begin the year with a price somewhere between one penny and $10,000.

Over time, as more information is acquired about the probability of the payoff, the risk attached to the investment will rise and fall according to the portent of the additional information. Whenever the probability of reaping the return increases, the price of the asset will increase, reflecting the decline in risk. And whenever the return seems less likely, the asset price will decline reflecting the increase in the risk of the investment.

Windfall Gains

Frequently in making an investment an investor is aware of a wide range of possible outcomes, some of which include exceptional capital gains and losses. The investor may also be aware of the possibility of exceptional capital gains and losses from sources that were entirely unexpected. Such a windfall might arise, for example, if a farmer were suddenly to find a large reserve of recoverable oil on his land, while he risks a significant loss if he suddenly finds some rodents listed as endangered species living in his fields. In each case, these windfalls are distinguishable from other sources of capital gains because they are entirely unexpected.

Capital Gains and Small Businesses

Investors in a small business hope for extraordinary returns to compensate for the high degree of risk inherent in their investments. While any of the described sources of capital gains may appear in a small business investment, clearly the only source that offers the necessary and reasonable potential for achieving the desired rate of return is that due to risk. Capital gains tax relief intended to benefit small businesses should be sure to reduce the tax liability from such gains the most.

Reforming the Capital Gains Tax for Small Businesses

While derivatives and fancy, high-risk financial instruments get the headlines, few investments bear as much risk as an investment in a small business. Consequently, these investments must offer a reasonable expectation of extraordinary returns to lure investors' dollars. The capital gains tax raises the pre-tax returns investors will expect.

Capital gains tax relief may take the form of either a reduction in the tax rate, a simple exclusion of taxable gain, indexation of the tax base (generally, the purchase price of the asset), or an increase in the amount of capital loss that can be charged against ordinary income in a given year. Each form of relief would improve a business's ability to raise equity capital.

In considering an investment in a small business, an investor will recognize that capital gains tax liability will probably arise if the investment is successful. On the other hand, in the far more likely event that the business will not succeed and some or all of the initial investment will be lost, the amount of capital loss that may be claimed for the year may be limited. The Internal Revenue Code allows the taxpayer to use capital losses to offset capital gains. However, if the losses exceed the gains for the year, only $3,000 of the excess capital loss may be used to reduce taxable ordinary income. Any excess capital losses over this amount must be carried forward into the future.

Often, and perhaps typically, the friends and family who invest in a small business do not have extensive portfolios that allow the type of asset management that would avoid having to carry capital losses into future tax years. This can significantly reduce the present value of the capital loss and raise the effective tax cost of the investment. Since such a loss is a distinct possibility facing any small business investor, the constraint on the taxpayer's ability to reduce current taxes using capital losses raises the required return on the investment even further. While it is often more popular to reduce the tax rate on capital gains as they represent the returns to successful activity, from the standpoint of the investor, increasing the limit on how much capital loss can be charged in a given year to ordinary income can be every bit as valuable.

Suppose an investor loses $24,000 in principal on an investment and the investor has no capital gains that may be realized to offset the capital losses. With a $3,000 annual limit, eight years would pass before the taxpayer would be able to exhaust the capital losses. In present value terms, therefore, this $24,000 capital loss is worth only about $19,000 at today's interest rates.

Indexing capital gains for inflation is widely recognized as the most fair and most theoretically correct means of providing capital gains relief. It is patently unfair to tax capital gains due solely to inflation, particularly when inflation is, itself, the product of government actions. For small business owners, however, indexing often provides less relief from the capital gains tax than does a simple exclusion. The mechanics of indexing are that

the purchase price of the asset is increased by the percentage increase in the price level. This adjusted basis is then subtracted from the sales price to determine the taxable capital gain. Generally, the basis (or original value of the business) is very low, so that the indexing adjustment is applied to a relatively small amount.

For example, suppose a business is worth $25,000 when founded in 1974. In the intervening years, the general price level has risen by a factor of 3, so the inflation-adjusted basis for tax purposes would be $75,000. If the business is sold for $100,000, then indexing has protected the investor from owing capital gains tax on purely inflationary gains and taxes will only be owed on $25,000 in real capital gains [$100,000 - $75,000]. In contrast, however, if the taxpayer were allowed a 50 percent exclusion, then he would have a taxable capital gain of $37,500 [($100,000 - $25,000)x50 percent]. In this case, indexing is clearly preferable to a simple exclusion.

Suppose the final sales price were $250,000, instead of $100,000 as in the previous example. In this case, under indexing the taxpayer would have a taxable capital gain of $175,000 [$250,000 - $75,000 in adjusted basis], whereas a 50 percent exclusion would leave the taxpayer with a $112,500 taxable gain [($250,000 - $25,000 in original basis)x50 percent], which is clearly preferable to indexing. Moreover, as the final sales price increases relative to the purchase price, the tax relief from a simple exclusion becomes progressively more attractive than that from indexing.

In passing, it is important to note that for most taxpayers most of the time, indexing provides more relief than would a simple exclusion. Only in rare cases when the tax basis is very small relative to the final sales price, i.e., as occurs for the investor in a successful small business, is a simple exclusion less preferable. Virtually all other criticisms of indexing, such as those dealing with complexity or with the possibility of tax sheltering, are either incorrect or grossly exaggerated.

Tax Fairness

In recent years the issue of tax fairness has made reasonable debate about the efficacy of capital gains tax relief nearly impossible. For example, indexing capital gains for inflation is widely regarded as fair and at least theoretically correct tax policy even by those who have reservations about indexing on other grounds. Nevertheless, many Members of Congress and some segments of society oppose capital gains tax relief in general, while supporting indexing in particular. It follows that opposition to capital gains relief predominantly relates to real gains.

General opposition to capital gains tax relief derives from a desire to equalize the distribution of wealth through tax policy. Obviously, the wealthy will receive most of the capital gains in society in pure dollar terms. However, the importance of capital gains and capital gains relief may be greater for lower- and middle-income families than it is for upper-income families because these gains, when they arise, may represent a far greater share of

the family income than they do for wealthy families. Recent Tax Foundation research supports this supposition. This research shows that nearly 20 percent of all taxable capital gains accrue to families with incomes below $50,000 annually, and that over half of all taxable capital gains accrue to families with incomes below $200,000.

Finally, while it is appropriate to consider whether a specific tax policy or change in policy is fair, it is important to place these matters within the context of the overall tax policy and even within the overall economic policy of the government. Capital gains relief is proposed for two solid economic policy reasons--to increase the rate of saving and investment in the United States, and to increase wages and employment.

The capital gains tax represents an explicit choice in economic policy favoring a high degree of income redistributionism at the expense of a stronger economy and a more prosperous people. The net result may or may not be a more "equitable" distribution of the fruits of our economy, but it is a peculiar sense of fairness that would choose such a distribution when the cost of such a policy is that all members of society have less income and less wealth.

Other Policies for Encouraging Small Business

A basic principle of Tax Foundation analysis is that the tax code should not be used to micro-manage the economy. While such an operating rule would disqualify certain tax proposals, there are more than enough instances in the federal tax code where disincentives have been created whose removal would both help small businesses and reduce the government's interference in the marketplace.

The short history of a small business described above should indicate some ways in which a change in tax policy would foster small business success. For example, capital gains relief would make it easier for small businesses to expand. Payroll tax relief, however, would be most beneficial for businesses when they are first starting out or whenever they are in financial distress because the payroll tax creates a serious drain on vital cash flow. Many forms of income tax relief would help small businesses, including raising the amount of capital expenditures that may be expensed in a given year; making the Research and Experimentation Tax Credit permanent; and giving all taxpayers the ability to deduct their health insurance premiums whenever they do not enjoy employer-provided insurance.

Tax Complexity

Among the many burdens a small businessman must face is compliance with the federal, state, and local tax codes. Too small to hire professional help the small businessman must proceed as best he can through the tax forms and regulations, all under threat of severe penalty. Tax Foundation research indicates that the average business with sales of $1 million or less (which represents over 80 percent of the corporations in America) must spend over $5,000 annually complying with the federal tax system alone. Tax reform efforts that

would simplify the tax code, thereby freeing both time and financial resources for more productive activities, would be equivalent to explicit tax relief from the small businessman's perspective, and yet could be achieved with no loss in federal tax receipts.

Conclusion

While small businesses have much in common with their larger brethren in terms of tax concerns, one matter which distinguishes them is their ability under normal circumstances to access the nation's capital markets to acquire the seed corn necessary to develop and expand. Another aspect which tends to distinguish small businesses is the prospect of very great returns if the business flourishes, and the possibility of losing much or all of one's investment if the business does not succeed. In each case, properly crafted capital gains tax relief would ease these burdens on small businesses tremendously.

Thank you for this opportunity to testify on the capital gains tax cut provisions of H.R. 9, the "Job Creation and Wage Enhancement Act," a key element of the House Republican "Contract With America."

The AFL-CIO is unalterably opposed to further expansion of the already considerable tax preferences that are accorded to income derived from capital gains. The proposition that capital gains tax cuts would create jobs or enhance wages is a cynical hoax. Whether viewed from the perspective of fairness, budget impact, or stimulus to productive job-creating investment, H.R. 9's capital gains tax cut proposals flunk every test.

Fairness is an important yardstick for evaluating any tax policy proposal. It is inherently unfair to tax the wages and salaries of working people at a higher rate than the capital gains realized by the wealthy on their sales of stocks, bonds, real estate and other property. Capital gains tax preferences simply are not available to most working people who pay the lion's share of taxes and who must meet their income tax obligations every payday. What AFL-CIO President Lane Kirkland noted several years ago remains true today: capital gains tax preferences are for the exclusive benefit of those whose money works for them, not for those who work for their money.

Even without the deep capital gains tax cuts that are proposed in H.R. 9, recipients of income from capital gains already benefit from a variety of tax preferences. The 1993 increase in the top tax rate to 39.6% on amounts of income in excess of $250,000 did not apply to capital gains, which face a maximum tax rate of only 28%, a full 11.6% lower. A brand new tax preference for capital gains was created in 1993, moreover, in the form of a maximum 14% tax rate on gains associated with certain new investments and newly issued stock. Furthermore, the capital gain associated with assets that are passed on from one generation to the next escapes income taxation completely if the gain is unrealized at death. Other tax preferences too numerous to mention already benefit the recipients of capital gains.

It is difficult to overstate just how skewed in favor of the wealthy these existing capital gains tax preferences are. The richest one per cent of families derive 22% of their incomes from capital gains, and receive nearly two thirds of all capital gains generated in the economy. This privileged elite makes more than 50 cents in capital gains for every dollar it earns in wages and salaries. Even the fourth richest quintile of families, by contrast, derive only one per cent of their incomes from capital gains, and recieve only five per cent of the capital gains generated in the economy. For every dollar they earn in wages, they receive capital gains of less than two cents. A remarkable 96% of the tax benefits from the current 28% maximum capital gains tax rate accrues to the richest one per cent of taxpayers, those whose incomes exceed $200,000 per year, according to the Citizens for Tax Justice.

The further deep cuts in capital gains taxes proposed in H.R. 9 would make a bad situation dramatically worse. The huge 50% reduction in tax rates applied to capital gains compared with ordinary income, coupled with indexation, would exclude almost two thirds of capital gains from taxation. In a typical example provided in recent Treasury Department testimony, the effective tax rate on income from capital gains would amount to less than nine per cent. Fully 70% of the aggregate benefits from the proposed capital gains tax cuts contained in H.R. 9 would accrue to the richest one per cent of taxpayers, those with incomes in excess of $200,000 per year, again according to the Citizens for Tax Justice. For members of this fortunate group, the average tax reduction would exceed $16,000 per year. By contrast, taxpayers with incomes of $50,000 or less could expect a tax break of $60 or less.

Proponents of capital gains tax cuts attempt to dismiss these kinds of criticisms by terming them evidence of envy, or attempts to foment class warfare. These criticisms are not accurate. Envy is not the same thing as fairness, which lies at the heart of the debate around taxation of capital gains. It is not fair to tax the capital gains of the wealthy at a preferential rate compared with the hard-earned wages and salaries of working people. It is not class warfare to suggest that the most economically fortunate Americans who have derived the greatest benefits from our economic system should pay their fair share of the taxes that are needed for that system to function effectively.

Budget Impact

According to the Treasury Department, the capital gains tax cuts proposed in H.R. 9 would deprive the nation of $61 billion in badly needed revenues over the next five years, and would cost $183 billion between 1995 and 2005. The dogged insistence by some proponents that deep cuts in capital gains taxes will not cause revenue losses is sheer economic nonsense. If history is any guide, any boost in revenues will be highly transitory, while the subsequent decline in revenues will be far larger, and permanent. Longer term, lower capital gains tax rates are associated with lower revenues, and higher rates are associated with higher revenues. Between 1981 and 1985, for example, a 20% capital gains tax rate yielded revenues averaging $18.4 billion per year; between 1987 and 1991, with the tax rate at 28%, revenues averaged $32 billion per year.

Beyond the revenue loss and the inequitable distribution of the proposed capital gains tax cuts, the AFL-CIO has serious concerns about how the cuts would be financed. The elaborate detail of the capital gains tax cut proposals in H.R. 9 stand in marked contrast to the rest of the Contract With America's failure to identify specific spending cuts to pay for them. While it is true that a high proportion of the American public express understandable frustration to pollsters by advocating less government, most people do not favor cuts in specific programs such as education, job training, health care or transportation, and with

good reason. Such programs can have a far greater bearing on their economic opportunities and quality of life than a tax cut, particularly a tax cut that will accrue almost exclusivley to the most wealthy and privileged members of our society.

For most working families, lower capital gains taxes raise the specter of cutbacks in many areas, such as student loans which may deprive their children of the chance to obtain an education, or in job training programs which could assist breadwinners who lose their jobs in a turbulent economy, and for no other purpose than to finance ill deserved multi-billion dollar tax breaks for the nation's most privileged economic elite.

Investment, Economic Growth and Jobs

Despite their inherent unfairness and devastating budget impact, these and other shortcomings would be less onerous if the proposed capital gains tax cuts could be counted on to stimulate productive investment, economic growth and jobs. Unfortunately they cannot.

Capital gains tax cuts have very little to do with productive investment as economists define it. The cuts apply to all transactions involving the purchase or sale of financial or tangible assets, whether any actual investment takes place or not. It is difficult to see any link between increased after-tax profits accruing to wealthy art collectors upon the sale of their paintings and the enhancement of the nation's productive physical capital stock. Fully 97% of stock market transactions involve trading existing shares of corporate stock. These transactions are an enormous source of capital gains for wealthy investors, yet they do not directly provide the nation's businesses with a single penny of additional resources with which to make real investments to retain or create jobs. Cutting taxes on these kinds of paper capital gains will not boost productive job-creating investment.

Nor is there any guarantee that productive investment, if it should take place, would occur in the United States. The U.S. tax code is already rife with provisions that reward corporations and wealthy investors for exporting or destroying U.S. workers' jobs. With a trade deficit in manufactured goods that increased last year to a record $156 billion, the last thing we as a nation need or can afford is another untargetted tax break that underwrites the export of even more jobs.

Furthermore, if the Federal Reserve Board takes capital gains or other tax cuts as a signal to raise interest rates, as it probably would, any possible benefit in terms of increased investment would be overwhelmed by the adverse impact of higher interest rates on economic growth and jobs.

With a theoretical basis this shaky, it is not surprising that a number of empirical studies have failed to find any evidence for a link between lower capital gains taxes and higher productive

investment to create or retain jobs. I urge the members of this Committee to review carefully the results of these studies, and not be seduced by the bogus claims of economic benefits that are alleged to flow from a capital gains tax cut.

The only economic activity that can reliably be predicted to be stimulated by a capital gains tax cut is the services of lawyers and accountants employed by the tax shelter industry. Tax shelters are heavily based on schemes to convert ordinary income into preferentially taxed capital gains. As noted earlier, the huge 50% differential contained in H.R. 9, coupled with indexing, will exclude almost two thirds of capital gains income from taxation. This will prove to be an irresistible lure to many wasteful, revenue losing and highly inequitable tax shelter activities.

There Is A Better Way

Instead of further cuts in capital gains taxes, current preferences for capital gains should be phased out. In particular, capital gains should be taxed at the same rate as ordinary income, and unrealized capital gains should be taxed at death. Safeguards could be included to prevent forced liquidation of assets, such as family farms, to pay capital gains taxes.

Taxing capital gains at the same rate as ordinary income would generate additional revenues of $15 billion per year, or perhaps much more. Taxing unrealized capital gains at death would yield additional revenues of $35 billion over the next five year, even excluding gains on assets that a spouse inherits or are donated to charity, and even with safeguards to prevent forced liquidation of assets to pay taxes.

In summary, the capital gains tax cut provisions of H.R. 9 are not fair, they would have a severly negative impact on the federal budget, and they would not stimulate productive investment, economic growth, or the creation or retention of jobs.

Thank you for this opportunity to testify.

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Statement of Jane G. Gravelle
Senior Specialist in Economic Policy
Congressional Research Service

Before

The Committee on Small Business
United States House of Representatives

February 22, 1995

on
Capital Gains Tax Proposals

Mr. Chairman and Members of the Committee, I am Jane G. Gravelle, a Senior Specialist in Economic Policy in the Congressional Research Service of the Library of Congress. I would like to thank you for the invitation to appear before you today to discuss capital gains tax cut proposals. While my discussion deals in general with the issues surrounding capital gains tax proposals, at several points it explicitly addresses the proposals in the House Republican Contract with America. I first discuss some of the general economic effects of the capital gains tax proposal, and then some specific issues of concern to small businesses.

Summary

The revenue consequences of cutting the capital gains tax may be larger than those currently estimated. Estimates of the taxes lost from lowering the capital gains tax rate include an offset for additional taxes collected on increased realizations that arise from the lower tax rates. Estimates thus depend on the magnitude of this realizations response, which

is in turn based on statistical evidence about the relationship between realizations and tax rates. This current offset is substantial relative to the static revenue cost. New evidence on the size of this realizations response suggests that the magnitude used in current revenue estimates may be too large and that the revenue cost of a fifty percent exclusion, for example, may be twice as large as estimated. In addition, the long run cost of the capital gains tax cuts in the Contract will be larger because of the growth in the cost of indexing. Because indexing only applies to inflation occurring after the revision, the inflation component of gains will grow over time. This effect alone could also more than double the cost relative to an exclusion, and the combination of both effects (a smaller realization response and the eventual effect of indexing) could increase the cost of the exclusion by several times. Note, however, that the revenue cost (currently estimated at around $53 billion in the first five years, with $16 billion due to indexation) is small relative to the total U.S. economy.

The effects of a capital gains tax cut on the capital stock, labor supply, and output are likely to be modest, particularly in the short run. Even using estimates from the empirical literature favorable to a larger and positive effect indicate very small increases in economic growth arising from the capital gains tax cut in the Contract. This modest effect arises from the small size of the tax change relative to the economy, the evidence of a limited ability of tax policy to influence private savings behavior, and the slow pace of the capital accumulation process. With less favorable assumptions, the effect on economic growth could be negative.

Any effect on asset prices is likely to be small and transitory, exerting only timing effects on revenue gains.

An argument made for cutting the capital gains tax is that lower rates would increase economic efficiency, primarily by reducing tax barriers to sale. Capital gains tax cuts could also affect the allocation of capital in other ways. The efficiency effects of cutting capital gains taxes are mixed, although they seem more likely to result from cuts in capital gains taxes on

corporate equities than for real estate. Whether indexation rather than an equivalent rate cut leads to greater economic efficiency is not clear. With regard to equity concerns, capital gains are penalized because of the taxation of inflationary gains, but benefit due to deferral and non-taxation of gains passed on at death. Most direct benefits of a capital gains tax cut will accrue to high income individuals. Finally, with respect to administrative issues, indexation will probably complicate administration and compliance.

The indirect effects of capital gains tax cuts on small businesses would probably be negative but relatively small. Owners of small businesses who sell business property could benefit from the provision. While it is not clear that additional tax subsidies for small businesses are optimal, or that a capital gains provision would be the most efficient method, there are several ways of targeting capital gains to allocate more of the benefits to small businesses.

General Economic Issues

Revenue Costs

Given our current concern for the size of the budget deficit, an important issue is the potential revenue loss from capital gains tax cuts. For example, the Contract proposal, which would allow a fifty percent exclusion for capital gains and allow for indexing for inflation occurring after 1994, is currently estimated to reduce revenues by around $54 billion by the Joint Committee on Taxation (JCT) for 1995-2000, and $170 billion for 1995-2005. If tax cuts increase the budget deficit and are not otherwise paid for, the effect will be to reduce the nation's savings.

The consequences for the budget deficit may be markedly different from those indicated by the current five year revenue estimates. First, the revenue cost of the capital gains tax cut is dependent on the size of the realizations response which may be currently overestimated,

thereby underestimating the cost of the capital gains cut.[1] Second, the revenue loss associated with the proposal will likely be much larger beyond the 5-year budget window, in part because of the rapid growth of the loss due to indexation, which will cover an increasing fraction of sales.

There has been considerable disagreement over the past few years over the revenue consequences of a capital gains tax cut. The Joint Committee on Taxation includes in its revenue estimates the expectation that individuals will respond to lower capital gains taxes by increasing realizations of capital gains. These increased realizations of capital gains will then produce additional taxable gains and additional revenue which will offset the static revenue loss. (The static revenue loss is the loss arising from the lower tax rate assuming there is no behavioral change.) This projected increase in realizations will be substantial and will lower the static estimate in the 5-year budget window for the fifty percent exclusion by more than sixty percent.

There has been a substantial body of empirical research on the realizations response, which has yielded a wide range of estimates. This empirical research is, for a variety of reasons, very difficult to perform, and all of the studies have been subject to a variety of criticisms.

In recent years, new evidence has been presented that suggests that this realizations response may be smaller than that assumed in the past, especially after the first few years.

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[1] This issue is discussed in more detail in my testimony before the Senate Finance Committee, February 15, 1995. For the literature discussing this realizations response and some of the difficulties associated with this research, see, for example, Gerald E. Auten, Leonard E. Burman and William C. Randolph, Estimation and Interpretation of Capital Gains Realizations Behavior, National Tax Journal, September 1989, pp. 353-374; Can a Capital Gains Tax Pay for Itself? by Jane G. Gravelle, Congressional Research Service Report 90-161, March 23, 1990; Gerald E. Auten and Joseph Cordes, Cutting Capital Gains Taxes, Journal of Economic Perspectives, Winter, 1991, pp. 181-192; George R. Zodrow, Economic Analyses of Capital Gains Taxation: Realizations, Revenues, Efficiency and Equity, In Tax Law Review, Vol. 48, No. 3, 1993, pp. 419-527; Jane G. Gravelle, The Economic Effects of Taxing Capital Income, Cambridge, MIT Press, 1994, p. 143-151.

Because of the wide variation in estimates based on statistical analysis, I prepared an alternative method of assessing the likely size of the realizations response.[2] This analysis is based on a relatively simple observation -- in the long run, realizations cannot exceed accruals. That is, realizations would equal accruals over a long period of time (year after year) only if individuals sold all assets after holding them less than a year. Indeed, one would never expect that all gains would be constantly realized, even in the absence of taxes and other transaction costs. The observation of historical ratios of realizations to accruals can be used to measure the upper limit of the realizations response and to suggest a likely size of that response. This analysis suggested a lower, perhaps much lower, permanent realizations response than that measured in most statistical studies. Basically, this type of approach provides a "reality check" on statistical estimates.

Most critics believed that a major problem with certain types of studies (cross-section studies) was that they could not control for timing effects. It is advantageous for individuals whose tax rates fluctuate from one year to the next to realize gains in years when tax rates are low. Thus, the relationships found between low tax rates and high realizations could be reflecting in part, or perhaps primarily, responses to temporary changes in tax rates -- responses that would not hold up for a permanent tax rate change. Indeed, the surge in realizations in 1986 when tax rates were scheduled to go up the next year is evidence of the power of this timing effect.

A recent statistical study which used a new approach -- variation in tax rates across States -- to control for transitory effects that had long plagued microdata statistical studies

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[2] See Limits to Capital Gains Feedback Effects, by Jane G. Gravelle, Congressional Research Service Report 91-250, March 15, 1991.

also found much smaller realizations responses.[3] These results were consistent with the effects that were suggested by the study of the historical measures of realizations and accruals.

If the findings in these recent studies are correct, the revenue estimates for the fifty percent exclusion could be more than twice as large as they would be based on current revenue estimating assumptions.[4]

Secondly, the indexing feature of the capital gains tax cut proposal is a provision that costs much less in the five year budget horizon because it applies only to inflation after 1994. The loss from indexing grows rapidly, however.

On a static basis, this provision might eventually increase the revenue cost associated with the exclusion alone by about fifty percent after it takes full effect. Because of the realizations response, however, adding this provision on top of an exclusion would more than double the revenue loss because it would apply to a much expanded base.[5] Both changes would increase the cost by several times.

The ten year estimates indicate some of this growth: the Joint Committee on Taxation estimates a $170 billion revenue loss over ten years; the second five year estimates are twice the size of the first five years.

If the cost is much larger than budget projections, either the revision will decrease national savings through a higher budget deficit or require larger offsetting changes elsewhere

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[3] Burman, Leonard E. and William C. Randolph, Measuring the Permanent Responses to Capital Gains Tax Cuts in Panel Data, American Economic Review, September, 1994, pp. 794-809.

[4] This calculation assumed a coefficient of 3.5 for prior revenue estimating assumptions and a coefficient of 1 for a revised estimate, using a semi-log estimating function and assuming the reduction in tax rates is 45 percent in the case of the coefficient of 1 and slightly less in the case of the higher coefficient. (If realizations increase a lot, they drive individuals into higher tax brackets, which causes the revenue loss to be even smaller).

[5] This estimate assumes that inflation indexing is roughly equivalent to another fifty percent exclusion.

to maintain budget deficit neutrality. Note, however, that although these revenue losses may be significant with respect to the size of the deficit, they are small with respect to national output.

Savings and Economic Growth

It may be surprising to some to learn that we cannot be sure whether cutting taxes on capital income will increase savings. Economists have long recognized that the response of saving to the rate of return is uncertain due to the opposing forces of "income" and "substitution" effects. When the rate of return rises, a substitution effect might cause an individual to prefer more consumption in the future (because the price of future consumption has fallen in terms of foregone present consumption) and increase savings. At the same time, there is an income effect -- the higher rate of return can allow savings to be smaller and still increase consumption in the future (and in the present as well). For example, if an individual were saving a certain amount for retirement, he could obtain that objective with a smaller amount of savings when the rate of return goes up.

Because of this theoretical ambiguity, it is necessary to turn to empirical research to determine whether private savings will increase, and empirical evidence would be necessary in any case to determine the magnitude of any effect. While it is very difficult to perform this analysis, this body of research suggests that effects of higher rates of return on savings have small positive effects on savings behavior and, in some studies, negative effects.[6] That is, it is possible that cutting capital gains taxes will reduce savings.

The process of altering the capital stock through a change in the savings rate is a very slow one that takes many years. Even with a large percentage increase in savings, the effect

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[6] For a summary of this literature, see Jane G, Gravelle, The Economic Effects of Taxing Capital Income, Cambridge, Mass., MIT Press, 1994, p. 27.

on the capital stock and on economic output will be modest because savings is very small relative to the capital stock.

Finally, it is likely that the effect of the proposed capital gains tax cuts on economic output and growth will be modest, even with a large response, because the tax change itself is not that large relative to the economy. Based on data from 1992, the fifty percent exclusion has the effect of reducing the cost of capital by 9 basis points and the combination of the exclusion and indexation reduces the cost by about 16 basis points. Measures based on this year are probably somewhat understated because realizations have been depressed due to the recession and low real estate values.

To illustrate these points, I use a simulation model that traces, over time, the response to a capital gains tax cut of a general magnitude similar to that proposed in the Contract (equivalent to a two percentage point reduction in the capital income tax rate, or a reduction in the cost of capital of 18 basis points), using assumptions favorable to a larger positive effect of the tax.[7] A savings response at the upper end of the estimates in the empirical literature is chosen. This response is in the form of a savings elasticity (the percentage change in the savings rate divided by the percentage change in the rate of return), and is set at 0.4. Such a measure implies that a ten percent increase in the rate of return will lead to a four percent increase in the savings rate.

Several aspects of this simulation are chosen to be favorable to a large effect, including not only a larger, and positive, savings elasticity, but also an assumption that any revenue losses are recouped through some mechanism that does not otherwise alter the economy's economic behavior. Despite these favorable assumptions, this model indicates that even after five years, the capital stock has increased by less than 2/10 of a percent, the labor supply by

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[7] This model is presented in more detail in my testimony before the Senate Finance Committee, February 15, 1995.

1/100 of a percent, and the output level by 1/20 of a percent. After 110 years, output has increased by only one half of one percent.

It is relatively straightforward to see why these effects are so small in the short run. Consider the first period after the rate of return rises. Suppose it rises by about 4 percent. That implies an increase in the savings rate of 1.6 percent (4% times the elasticity of 0.4). But savings is about two percent of the capital stock, which implies that the capital stock will increase by only 3/100 of a percent. Finally, given that capital contributes only twenty-five percent of output, the effect on output is less than 1/100 of a percent. After five years, therefore, the effect on output would be about five times as large, or about 1/20 of a percent. Thus, although the estimates are calculated in a more complex general equilibrium model (that allows for labor supply response and feedback effects on wages and rates of return), these results, at least in the first few years, could be approximated with a "back-of-the-envelope" calculation.

Note that these small effects also indicate that the possibilities of recovering much of the revenue loss through economic growth are extremely limited in the short run. For example, in the first five years, increased taxes on induced income would recoup only one percent of the original revenue loss.[8]

It is important to note that models that have found very large effects on the capital stock of tax cuts, including the capital gains tax cut, use the assumption of an infinitely elastic savings response and a rapid adjustment period. This is an assumption, not evidence from the economics literature.[9]

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[8] This issue of feedback effects on tax revenues is discussed in more detail in Dynamic Revenue Estimating, by Jane G. Gravelle, Congressional Research Service Report 94-1000 S, December 14, 1994.

[9] Note also that one argument used to justify a large savings response, international capital inflows, is not germane to this issue, since the capital gains tax applies to residents regardless of the location of capital and does not apply to foreign investors.

Under less favorable assumptions (e.g., effects on the budget deficit are not offset and/or the relationship between savings and the rate is return is negative), the capital gains tax cut could contract the economy and slow economic growth by reducing national savings.

Asset Values

Another argument that has been made is that the capital gains tax cut will increase asset values and therefore increase capital gains revenues. A recent study by DRI/McGraw-Hill suggests that equity values would rise by 5.5 percent and thereby produce several billion dollars of additional revenue. This effect is characterized as one of the largest ones for offsetting revenue.

There are several problems with this analysis. Presumably, this calculation is based on measuring the discounted present value of returns holding the prior discount rate constant and using an infinite time horizon. For a similar exercise, I obtain a measure of 4.3 percent.[10] First, this asset effect occurs because of a disequilibrium -- a discrepancy between the after tax rate of return paid and that which satisfies investors. Once that discrepancy disappears, a dollar's worth of physical capital (i.e. capital valued at the cost of constructing it) capital will be worth a dollar's worth of asset value. It is, therefore transitory, and a method of measuring it that assumes it is infinite is incorrect. As an illustration, suppose the discrepancy persisted for only five years and then a sudden adjustment is made. In that case, the asset price increase will be a third as large -- 1.5 percent. Furthermore, there will be a fall in the price in the

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[10] This estimate assumes an inflation rate of 3 percent, a real growth rate of 2.5 percent, a dividend rate of 4 percent, an initial tax rate of 25 percent for capital gains and 31 percent for dividends, an exclusion of 45 percent, a holding period of five years, a presumption that 43 percent of gains are never realized, and a presumption that 30 percent of assets are held by tax exempt investors such as pension funds. The present value per dollar of asset is the new after-tax internal rate of return divided by the old after-tax internal rate of return.

second year, the third year, etc., until the price falls back to its original value.[11] Thus, any effects that occur will be much smaller than those suggested by the asset value calculation.

In addition, any gain that might occur initially will be subsequently offset. If asset prices rise, they will increase gains, but once they fall, they will reduce gains (or cause losses) since individuals purchased them at the higher values. In the long run there will be no effect; rather there will be an offsetting gain in revenue, followed by a loss that will further add to revenue costs.

It is very difficult to determine the transition period for this process (which could involve both a rise in the discount rate and a fall in the pre-tax return). Holding aggregate savings fixed (as suggested would be expected in the analysis presented earlier), the increased demand for stocks by individuals could be accompanied with some or all of the following: an exit from the market of non-taxable investors because of the price rise (driving it back down), an increase in the discount rate necessary to attract more investors, an increase in interest rates as individuals forgo interest bearing assets (which would drive down the profits of corporations), and a substitution in the corporation of equity for debt accompanied by new stock issues. If portfolio substitution elasticities are relatively small, as some evidence suggests, the effect will occur largely in an increase in the discount rate and will probably occur quickly.

Efficiency

An argument for reducing the capital gains tax made by some economists is based on the distortions that the tax produces, primarily the barriers it imposes to sale (the lock-in effect). The capital gains tax may also contribute to distortions that disfavor corporate equity

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[11] The asset price would be higher by 1.2 percent in the second year, 1 percent in the third, 0.7 percent in the fourth, 0.3 percent in the fifth, and 0 percent in the sixth and following years.

investments, and reduce the distortions taxes introduce into savings decisions. How significant these distortions are found to be depends, of course, on the magnitude of empirical measures of realizations responses, investment allocation and portfolio responses, and savings responses. The distortion arising from lock-in could be significant as a fraction of revenue. At the same time, the proposed tax reductions could magnify other distortions, such as the choice of dividend payout ratio and distortions of other taxes if they are used to replace the revenue. Notably, the reduction extends to noncorporate investments (primarily sale of real estate) as well. The lock-in effect is also likely to less serious for real estate because any capital gains tax on the sale is offset by the ability to restart depreciation based on the normally higher nominal value.

Some economists also are concerned about the possibility of low capital gains tax rates playing a role in tax sheltering and avoidance activities. Unfortunately, the role of lower capital gains taxes in increasing or decreasing economic efficiency remains unclear. The case for efficiency gains is probably best made for corporate equity (stocks), but gains on these assets constitute only a fraction of gains (ranging from about 20 percent to 50 percent, depending on the relative performance of the stock market). Much of the remainder is gain on real estate.

Inflation indexing is probably less likely to reduce the lock-in effect than an exclusion of the same average value. The lock-in effect is most serious for assets that have been held a substantial period of time, but these assets will receive a smaller exclusion from indexing than short lived assets. For example, if a corporate stock is appreciating at a three percent annual rate and there is a three percent inflation, indexing for an asset held one year will result in

an exclusion of 49 percent of gain, while indexing for an asset held 20 years will result in an exclusion of 36 percent of the gain.[12]

Arguments are also sometimes made that the capital gains tax has an important influence on risk-taking, entrepreneurship, and the availability of venture capital, and hence productivity growth. While such a relationship may exist, there is little empirical evidence of a link between the capital gains tax rate and productivity growth. Also, much of formal venture capital offerings is not subject to capital gains taxation,[13] and the vast majority of capital gains accrue on real estate or sales of stock of long established corporations.

Equity Issues

An important argument for indexing capital gains is that gains include those arising solely from general price changes in the economy. These gains do not constitute real income and it may well be argued that it is unfair to tax them. At the same time, capital gains income benefits from other aspects of the tax law, including the ability to defer taxation of income and the ability of avoid taxation entirely on assets held until death. Higher income individuals also benefit from the current 28 percent cap. In addition, the taxpayer has the advantage of control over the realization of gain, so that he can choose to realize offsetting losses.

Whether, on average, these benefits outweigh the penalties imposed by taxing inflationary gains depends on average holding periods and inflation rates. Currently, it is

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[12] The value of an asset costing one dollar held for one year is 1.03 times 1.03 and the gain without indexing would be that amount, minus 1, or .0609. If the asset is indexed, the gains will be 1.0609 minus 1.03 (the latter number the basis increased by inflation), or .0309. The gain is reduced by 49 percent. For the asset held for twenty years, the gain is 1.03^{20} times 1.03^{20}, minus 1; the gain with indexing subtracts 1.03^{20} and the result is an exclusion of 36 percent.

[13] See James Poterba, Venture Capital and Capital Gains Taxation, in Tax Policy and the Economy, vol. 3,, ed. Lawrence Summers, National Bureau of Economic Research, MIT Press, Cambridge, 1989.

likely that the average effective tax rate on capital gains is lower than the statutory rate for corporate stock where such effective tax rates can be calculated. This effect varies across individuals and assets, depending on the holding period and the real appreciation rate. The combination of the fifty percent exclusion and inflation indexing will lead to effective tax rates well below the statutory rate.

Vertical distribution effects of the capital gains tax cut may also be of interest to the Committee. A capital gains tax cut will primarily benefit higher income individuals. When a thirty percent tax cut was proposed in 1990, the Treasury department estimated that 54 percent of the direct benefit would have gone to those with incomes over $200,000, a group constituting about one percent of the population. About 74 percent would have gone to the top five percent earning over $100,000.

Note that this effect is not primarily because of moderate income individuals receiving a once-in-a-lifetime gain and only appearing to be in a high income class. Classification was based on five year averages in order to mitigate the problem that individuals would appear in the higher group because of realization of a large gain in one year. Examined over five years, only ten percent of gains are realized by taxpayers with a gain in only one year.

Simplicity and Tax Administration

While, the addition of more tax preferences for capital gains is likely to induce greater efforts to covert ordinary income into capital gains, there is no inherent complication in actually computing capital gains with an exclusion. The proposal from prospective inflation indexing would, however, be more complicated. Unlike an exclusion, an inflation adjustment requires a separate adjustment for each vintage of assets.

Effects on Small Business

The capital gains tax cut could affect small businesses in two ways: through indirect effects on the economy as a whole, and through specific effects on small business enterprises.

In general, the analyses presented in this study suggests that any macroeconomic effects on the economy are likely to be quite small. There may be some tendency for portfolio shifts to drive up interest rates slightly, but this effect may be offset by reduced borrowing demands as firms choose to use more equity finance. It is possible that the proposal may generate a larger revenue loss than expected, thereby driving up interest rates slightly and temporarily as the deficit becomes larger than planned. These effects would also be quite modest. Thus, on the whole the overall macroeconomic effects are likely to be modest (but possibly negative).

Another indirect way in which a general capital gains tax cut could affect smaller firms arises because there is a present 50 percent exclusion for gain on original issue stock held for at least five years in certain small business firms (with assets less than $50 million). Provision of a more generally available tax benefit could make these investments less attractive in a relative sense.

The capital gains tax cut could also directly affect owners of small businesses, including small businesses organized as corporations and the sale of business assets. It is important, however, to note that most capital gains in the economy are from the sales of corporate stock of large, established companies and real estate, much of the latter sales by passive (non-business investors). Based on the last published data on sales of assets by type, business depreciable property accounted for 15 percent of capital gains of individuals other than personal residences; most of this category was probably business real estate.[14]

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[14] These data are from 1981, and they also include 9 percent in partnership distributions which could be a mix of passive and active investors and 10 percent in installment sales. Since 1981, corporate stock has become relatively more important as a share of capital gain.

It is not clear that further special tax benefits for small businesses would increase economic efficiency. In fact, tax rates on small businesses are already lower than those on large businesses, a treatment that favors small businesses relative to large ones. Nor is it clear that a capital gains benefit is the best method of providing such subsidies. Nevertheless, there are ways of targeting capital gains revision to smaller firms. For example, the current 50 percent exclusion for equity investments in small corporate firms could be liberalized in a variety of ways (e.g. increased and/or indexing the ceiling, extending the treatment to corporate investors, eliminating or increasing per investor limits on exclusions, eliminating the part of the exclusion that is a preference item under the alternative minimum tax). It would also be possible to provide a lifetime exclusion to individuals that would benefit smaller investors (including smaller businesses). An averaging provision could also ameliorate the problem of a one-time large gain pushing a taxpayer into higher brackets. Unfortunately targeted approaches of this type tend to add to administrative and compliance costs.

Small Business SURVIVAL Committee

Statement of
Richard W. Rahn, Ph.D.
Member of the Board
Small Business Survival Committee
on
Capital Gains Taxes and the Investment Impact on Small Business

Before
United States House of Representatives
Committee on Small Business
February 22, 1995

Chairman Meyers, members of the Committee, I thank the Small Business Committee for inviting me to testify before you today on the future of small business in America, and how the new Congress and the Administration can begin to further unleash investment and entrepreneurship in America to sustain long term economic growth and opportunity.

I am Richard Rahn, and I am a board member of the Small Business Survival Committee (SBSC), a 40,000-member nonpartisan, nonprofit, small business advocacy organization. I formally served as Vice President and Chief Economist for the United States Chamber of Commerce, and currently serve as President of Novecon.

If there is anything in America that represents attainment of the American Dream, it is owning your own business. Unfortunately, most small business owners and entrepreneurs cite their most daunting day-to-day obstacles of running their business as government-imposed -- namely, taxes and regulations. The government has become the main deterrent to small business prosperity and entrepreneurial activity, and I am encouraged that the 104th Congress is taking proactive steps to lift burdensome policies and requirements which are stifling economic growth and productivity.

If enacted, a capital gains tax cut will help to relieve a formidable obstacle faced by American business -- especially small business. While I fully support the elimination of the capital gains tax, the reduction and indexation as proposed in the *Contract With*

America would result in lower capital costs, increased capital formation, new and higher-paying jobs, and increased investment in start-up enterprises, as well as business expansions.

The United States is heavily dependent on its entrepreneurial and small business sector for its job creating capabilities and technological and innovative breakthroughs. The capital gains tax is a direct levy on investment and entrepreneurship, punishing and discouraging these activities. It is clear that the U.S. tax policies toward savings and investment must be revised if we are to retain our country's leading economic role, as well as retain the necessary status and clout to manage and provide leadership on all world affair issues.

Small Business Investment and Capital Gains Taxes
Impediment of an Entrepreneurial Economy

Too often, risk-takers and entrepreneurs with their promising ideas face a daunting obstacle in launching a new business -- raising capital. Business owners with profitable, growing companies can also hit a brick wall when seeking funding sources to expand their operations. The U.S. tax code in its treatment of capital gains, is a major barrier for such small business owners or emerging entrepreneurs.

The nation's economic future depends on the success of the entrepreneurial sector. Small business is our nation's job-creating machine. Investment in small business is critical to our nation. *While SBSC fully supports eliminating the capital gains tax, the Contract With America proposal which, combined with indexation, reduces the top capital gains tax rate to 19.8 percent, could be the most pro-growth step taken by the new Congress.*

Unfortunately, investment spending in the United States has largely continued on a downward path over the past 30 to 40 years. According to a 1994 study by the American Council for Capital Formation Center for Policy Research, net annual business investment in the U.S. has in recent years fallen to only half the level of the 1960s and 1970s. Net private domestic investment, according to the same study, averaged 7.4 percent of GDP from 1960 to 1980. Since 1991 it has averaged only 3.0 percent.

Lower investment spending in the U.S. renders less risk-taking and innovation. diminished productivity, fewer job-creating opportunities and, overall, weakened economic growth.

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There is no more important economic task than investing both sweat and capital in new ideas, innovations, and enterprises. Yet the risky nature of such ventures scares off bank lending officers. Therefore, venture capital, whether raised from one's family and friends or from professional investors, remains a critical source of funding for entrepreneurial enterprises. Such investors must determine if they will receive a fair return on their investment.

The capital gains tax is a direct levy on investment and entrepreneurship. Investment and entrepreneurship are the lifeblood of a vibrant economy and remain the engines of economic growth and job creation. The current, non-indexed federal tax rate of 28 percent on capital gains remains a formidable obstacle to economic expansion, especially considering the risky nature of investing, and starting and operating a business.

The potential benefits of reducing and indexing the capital gains tax are clear, and they will largely benefit small business. According to the American Council for Capital Formation, venture capital investment was on the rise as the U.S. capital gains tax rate declined up to 1986; followed by a dramatic downturn as the rate was hiked 40 percent in 1987, from 20 percent to 28 percent. Since the 1986 Tax Reform Act raised the capital gains tax rate by 40 percent, venture capital investment has nose-dived, and federal capital gains tax revenues have consistently run well below government expectations. (In fact, according to CATO Institute economist Steve Moore, 1991 revenue realizations equaled $108 billion versus a late-1980's Congressional Budget Office prediction of $269 billion and a Joint Economic Committee prediction of $285 billion.)

Higher capital gains rates discourage savings and investment, raising the cost of available capital. The effect of higher capital costs means lower levels of investment in plant and equipment, technology and labor. As a result, it costs more to produce goods and services, resulting in higher consumer prices. Already economies of scale make it more difficult for small businesses to compete with larger competitors. The higher cost of capital, and its resulting inefficiencies, impacts small businesses much more harshly.

Low capital gains taxes will help lower the cost of capital. Researchers have found that a cut in the capital gains tax rate to a range of 15 to 20 percent would reduce the cost of capital by 4 to 8 percent.

Indexation of Capital Gains

The nominal rate of federal taxation is 28 percent. However, when inflation is factored into the capital gains equation the *real* capital gains tax rate rises substantially. The willingness to invest is substantially hindered by taxing capital gains, which are "specter" earnings spurred by inflation.

The lack of indexation creates additional disincentives for investment and entrepreneurship, restraining small-business growth and job creation. In fact, some individuals can wind up paying taxes on real capital losses. That is, after factoring inflation into the equation, a nominal profit on a transaction can turn out to be a real loss, yet the investor still pays taxes on the nominal gains. Or put more simply, individuals still pay a substantial capital gains tax even though, after inflation, they receive less from their sale than they originally paid. From a "fairness" perspective this is unfair and makes no economic sense.

A 28 percent capital gains tax rate acts as a considerable disincentive to investment, while *real* rates to even paying taxes on a real capital loss, amount to economic suicide. Indexation would eliminate inflation as a factor in capital gains determination -- equalizing state and real capital gains tax rates. The lower real rate would reduce uncertainty, and generate investment, economic growth, and job creation.

A Capital Gains Tax Cut and the Fairness Issue

Opponents who dismiss lowering and/or eliminating capital gains tax rates are employing class warfare tactics which are based on false assumptions, and make no economic sense. Opponents of cutting capital gains taxes contend that this will result in a cash windfall to the nation's richest while the poor will continue to suffer. Not only does reducing/eliminating the capital gains tax make economic sense, but capital gains tend to be spread across a wider income spectrum than many believe (or want to believe.)

Based on 1992 federal income tax returns, 56 percent of returns claiming capital gains were from incomes of $50,000 or less, including the capital gain. Fully, 83 percent of returns with capital gains were from total incomes of less than $100,000.

The precept behind the opposition to a cut in the capital gains tax, is a false belief in the static nature of our economy and a "black and white" view of the world -- if one individual wins, then someone else has to lose. A cut in the capital gains tax will benefit all investors, and all income classes alike -- rich, middle-class, and lower middle-class -- because it would improve the economy's performance and growth potential.

Hard-working individuals and entrepreneurs who save and invest their money wisely are unfairly being punished for that activity. When high capital gains taxes punish investors of all income classes by gorging the value of their investments, or watering them down through the taxation of inflated gains, the response is to consume more now and to save and invest less. Government-imposed barriers to saving and investing hurts the economy and everyone in it. The siphoning of productive resources into the

unproductive and wasteful stream of government spending, is what can really be termed as unfair.

Governor Lawrence B. Lindsey, of the Federal Reserve, wrapped up the class warfare and fairness issue quite directly in a March 20, 1990 Op-Ed in the *Washington Post* entitled "Envy is No Basis for Tax Policy":

The political manipulation of envy is one reason why America has seen its competitive position in the world economy gradually erode during much of the postwar period. There may have been a time when America could afford to waste its resources in the name of envy, but that is a luxury we can no longer afford. ...The losers from the pursuit of envy are not only today's wealthy but everyone who benefits from a strong American economy, both today and in the future.

If the proponents of higher capital gains taxes were really interested in fairness they would insist that all losses be deductible in the way that all gains are taxed. It is hypocrisy to argue that we need high capital gains taxes for fairness, and then to argue for limitations on losses.

Targeted Capital Gains Tax Cuts

Small business, and entrepreneurial activity in general, will benefit from an across-the-board cut in the capital gains tax. Targeting a capital gains tax cut to certain industries assumes that politicians and bureaucrats in Washington can better pick winners and losers in the marketplace rather than the competitive economy can. Neither specific industries, nor smaller versus larger industries, should be "targeted" for the cut.

In addition to the misguided assumption that the government can and should choose what industries should be given favorable tax treatment, the government is further complicating an already mystifying and convoluted U.S. tax system. American taxpayers and most businesses are asking for a less-costly, less-complicated tax system -- not one that exacerbates its current complexity.

If a "targeted" approach is enacted, capital may indeed begin to flow to certain industries, but high capital gains taxes would continue to "lock-in" investors and keep capital from flowing to its most productive uses. Increasing the mobility of capital is important to free investors to pursue all their investment opportunities, not those hand-picked by the government. Investment decisions should be based on their merit, not on U.S. tax policy.

Targeting a capital gains cut also presents the problem of further politicizing the

U.S. tax code. Industries from across America will be lobbying Congress for their own favorable capital gains tax rate to attract investment.

The capital gains tax cut in the *Contract With America* is precisely the type of cut that the U.S. Congress should enact.

The "Cost-Effectiveness" of the Capital Gains Tax Cut

The Committee asked me to comment on the cost-effectiveness of the capital gains tax cut. This question assumes that there will be a major "cost" to the federal government in terms of tax revenues if a capital gains tax cut is enacted -- nothing can be further from reality. The question should be, what is the cost to the federal government (in terms of revenue foregone), and the economy when high capital gains taxes become U.S. tax policy?

There is no question that changes in tax rates affect how hard and long people work and how much they save and invest. The official revenue-estimating arms of the government in part ignore how tax policy changes human behavior in making these calculations. Indeed, at the heart of the debate in Washington right now is whether revenue estimators should employ static versus dynamic scoring to determine how much the *Contract's* tax cuts will "cost." This argument is important because static scoring has created a bias in favor of tax increases and against tax cuts.

All we need to do is to look at the Congressional Budget Office (CBO) and their track record in revenue estimating to show that indeed, when capital gains tax rates increased, the CBO failed in its attempt to accurately estimate government revenues. When the capital gains tax rate was raised from 20 to 28 percent in 1986, the CBO forecast that taxable capital gains would rise to $225 billion by 1989. The actual figure was $150 billion -- a miscalculation of about 50 percent or $75 billion.

Between 1988 and 1991, taxable capital gains fell below the 1985 level in every single year. By 1991 they were just half of what they were in 1985 (after adjusting for inflation) and lower than in any year since 1978. Incredibly, as late as 1988 the CBO was claiming that its computer simulations showed a "net revenue increase from the 1986 ACT."

In January of 1990, the CBO again miscalculated its capital gains revenue. They estimated that the government would realize $269 billion for 1991. They missed the mark by about 150 percent, as the capital gains realization was $108 billion.

Experience demonstrates that lower capital gains taxes have a beneficial impact on

federal revenues. If we look at recent t history, the evidence is indisputable. During the period of 1978 to 1985 the marginal federal tax rate on capital gains was cut from almost 50 percent to 20 percent. Total individual capital gains tax receipts increased from $9.1 billion to $26.5 billion. Capital gains realization swelled to $326 billion in 1986, and have trended downward ever since the Tax Reform Act of 1986 increased rates.

In addition to the fact that the federal treasury will gain from a capital gains tax cut, as noted earlier in my testimony, the entire economy will gain as well. Freeing capital to go to its most productive uses, and making capital available to new and growing businesses far outweighs any so-called "cost" to the federal government. Not only is cutting the capital gains tax the most cost-effective jobs program the government can enact, it will help the United States rapidly regain its competitive edge in the global economy.

How U.S. Capital Gains Tax Rates Compete Internationally

Higher capital gains tax rates undermine our nation's competitiveness while challenging our status as world economic leader. The current non-indexed capital gains tax rate is not competitive internationally.

Belgium, Germany, Hong Kong the Netherlands all have a zero rate on long-term capital gains. Canada, France, Italy and Sweden have lower capital gains than the U.S., with Japan's rate equalling 1 percent of sales price or 20 percent of net capital gain. Even the two nation's with higher nominal rates than the United States -- Australia and the United Kingdom -- allow for capital gains to be indexed for inflation. Hence, the U.S. *real* capital gains tax rate often will exceed the rate in Australia and the U.K., depending on U.S. inflation.

Given the critical and risky nature of investment and entrepreneurship, and the importance of maintaining a competitive environment in a global economy, capital gains should be excluded altogether. A zero capital gains tax rate would ensure that entrepreneurial risk taking, so crucial to economic growth, would not be impeded by the U.S. federal tax code. The fact is the capital gains tax is a double or triple tax because the income has been taxed at least once before, and in the case of corporate stock, twice before. The steps taken in the Contract With America to reduce and index the capital gains tax rate is a good start.

Urban and Inner-City Renewal

Renewing our inner-cities requires a comprehensive policy approach to resolve the

decay and dysfunction so prevalent in these areas. In addition to reforming federal tax and welfare policies that impact inner-city residents, states and cities must also take a very hard look at their current tax policies, regulatory structures, as well as spending priorities and inefficiencies to determine how such polices impact job flight and an anti-business climate.

However, a capital gains tax cut will indeed free up capital to new and emerging businesses, many of which do start up in our nation's inner-cities. As with many new businesses, fledgling start-ups will be helped by greater access to capital. Capital is scarce for most small businesses and entrepreneurs and, as mentioned, a cut in the capital gains tax will benefit all income classes in all areas.

Wages and Interest vs. Capital Gains

Opponents of cutting or eliminating capital gains taxes often argue that no reason exists for differing tax treatments between capital gains and, for example, wage or interest income.

In fact, there is a distinct difference between wage or even interest income and capital gains -- risk. Capital gains come from growth and appreciation of investments, which tend to carry greater risks than those associated with earning wages or even interest. In particular, investments in small, entrepreneurial ventures carry significant risk. As already noted, high-risk ventures must at least present the opportunity for rewards.

Another unfairness of the capital gains tax is that the government fully taxes, but severely limits losses. This discourages investors from engaging in high risk investments which are often the most productive.

Conclusion on Capital Gains Taxes

Small business is the engine of economic growth and job creation. In order to undertake and/or expand a small business, one needs capital. Without adequate capital, new ideas and businesses either never make it to the marketplace or they die a premature death. With such deaths go products, services and jobs. By taking the first step in the *Contract With America*, and indexing and reducing the capital gains tax rate, Congress and the Administration would greatly strengthen incentives for investment and entrepreneurship -- boosting economic growth and activity.

History shows that class warfare does not make for good economic policy. In fact, during the 1980's, while tax rates declined, upper-income individuals paid a greater share

of total income taxes, as the benefits of tax shelters declined and the rewards for working, saving and investment rose. In this environment, from 1980 to 1989, 18 million jobs were created.

The 1986 Tax Reform Act made positive strides by reducing personal and corporate tax rates, but went awry by trying to "pay" for these reductions with an increase in the capital gains tax rate. Indeed, the economy paid a price for this capital gains tax hike in the form of reduced venture capital investment.

The time has come to unleash entrepreneurial capitalism by first reducing and indexing, and then eliminating the capital gains tax.

Once again I thank the Committee, and look forward to answering any questions you may have.

CAPITAL GAINS TAXES AND SMALL BUSINESS

Testimony of Gary Robbins
Fiscal Associates, Inc.
Arlington, VA

Before the House Committee on Small Business
February 22, 1994

Madam Chairman and members of the Committee, I am Gary Robbins, president of Fiscal Associates, Inc. and Senior Research Associate of Tax Action Analysis. I appreciate the opportunity to speak to you today on the capital gains provisions in the "Contract with America."

The tax treatment of capital gains plays a large role in the investment decision of small businesses. Reducing capital gains taxes will expand investment opportunities for all businesses. However, what I would like to focus on today is the issue of how much it will cost to expand those investment opportunities. My remarks summarize a study that we just finished for Tax Action Analysis. The study has been made available to the Committee.

Over the next few weeks, the revenue effect of reducing capital gains taxes will play an important role in the policy making process. The larger the revenue loss attributed to capital gains, the greater the spending reductions that will have to be made somewhere else, making passage of a capital gains reduction more difficult.

The Joint Committee on Taxation has recently released its estimates of the cost of the capital gains tax proposal. The Joint Committee estimates that the capital gains reductions called for in the "Contract with America" will lose $53.9 billion over the next six years and $170.3 billion over the next ten. However, these estimates are at odds with the experience of the last seven years. Moreover, they point to an internal inconsistency in the method being used by the Joint Committee.

The last major change in capital gains taxation occurred in 1986. At that time and for several years later, government revenue estimators projected that elimination of the 60-percent exclusion would lead to a substantial revenue gain. By this year, the change should be picking up somewhere between $30 and $40 billion in *additional* revenue.

Tax return data, however, show that these revenue gains have not materialized. Instead, it appears that capital gains realizations are about 40 percent of what the government estimators promised. In other words, *taxable* realizations are the same as what they would have been under pre-1986 law.

This forecasting error has added $170 billion to the national debt between 1990 and 1994. Today, this error accounts for roughly 20 percent of the current budget deficit. Had

the Congress in 1986 known that little of the hoped-for revenue would be forthcoming, would it have raised capital gains taxes?

The capital gains proposal in the Contract would go a long way toward restoring the pre-1986 capital gains treatment. Our study shows that, using a modified version of the Joint Committee's method from 1990, the total revenue effect of the Contract proposal would be just about a wash. In other words, just as the 1986 increase picked up no additional revenue, the 50-percent exclusion proposed in the Contract would not lose any revenue. Instead, it would encourage expanded realizations that would offset the revenue loss on realizations that would have occurred under present law. Moreover, if as little as one-quarter of the roughly $1 trillion in locked-in gains that have been building since 1986 are realized, revenues would increase by an additional $25 billion over the next six years. In short, there will be nothing like the $170 billion revenue loss projected by the Joint Committee.

My discussion so far ignores the positive benefits of reducing capital gains taxes. In other words, the numbers to this point are on a *static* basis. We estimate that the capital gains proposal would add 0.4 percentage points to the U.S. growth rate, increasing output, investment and employment.

But, a capital gains tax reduction makes sense even without the growth argument. To reiterate, just as the 1986 capital gains change picked up little or no revenue, returning to something close to the old treatment would lose little or no revenue even on a static basis. Given the missed call in 1986, policy makers should insist that government revenue estimators review their methods, revise them where justified and make their findings public.

Institute for Research on the Economics of Taxation.

STATEMENT OF NORMAN B. TURE
PRESIDENT, INSTITUTE FOR RESEARCH ON THE ECONOMICS OF TAXATION (IRET)
CONCERNING TITLE I, H.R. 9
PRESENTED TO
THE COMMITTEE ON SMALL BUSINESS
U.S. HOUSE OF REPRESENTATIVES
FEBRUARY 22, 1995

SUMMARY

The reduction in capital gains tax rates and the inflation adjustment of the bases of capital assets proposed in Title I of H.R. 9 would contribute significantly to moderating the bias against saving imposed by the existing federal tax system. In view of the projected preemption of virtually all of the nation's saving by federal entitlement spending, easing the anti-saving tax bias is of the utmost urgency and should command top tax policy priority.

While these tax changes will improve the tax climate for all savers and investors, they will be particularly important for highly innovative, entrepreneurial businesses among which small and new businesses take a leading role. Innovative and entrepreneurial business activities, major sources of economic progress, depend heavily on access to saving for their funding.

The existing tax treatment of capital gains increases the cost of saving compared to consumption uses of current income. This anti-saving impact is exacerbated by taxing nominal rather than inflation-adjusted gains. Moreover, taxing realized gains, particularly without inflation adjustment, immobilizes accumulated savings and impairs the capital market's critically important function of assigning them to their most productive uses.

The proposed deduction from adjusted gross income of 50 percent of net long-term capital gains and inflation adjustment of basis would significantly improve the tax treatment of capital gains. These revisions would materially reduce the income tax bias against all saving, not merely that invested in property identified as capital assets. Both business and household saving are likely to increase substantially above levels that would otherwise occur, although the desirability of the proposed capital gains reform does not depend on how large the saving response will be.

Both of these proposed reforms would improve the efficiency of the financial markets by significantly reducing tax impediments to investors' changing the composition of their asset holdings in response to market signals. Realizing the benefits of innovation and technological advance often requires business restructuring. The application of the changes proposed in Title

I of H.R. 9 to corporate taxpayers is extremely important in reducing the existing tax barriers to changes in business ownership that are often needed for such restructuring.

Changes in asset holding and in business ownership, essential adjustments to dynamic changes in economic conditions, often result in capital losses. The limitations imposed by existing law on the offset and deductibility of losses impede these adjustments. A highly constructive improvement in the tax treatment of gains and losses would be to ameliorate the harsh treatment of capital losses, particularly those realized by corporate taxpayers.

Reducing the capital gains tax will increase the differential between the tax burden on distributed and retained corporate earnings. Enactment of Title I will increase the desirability of providing some relief at the corporate level for dividend distributions.

More severely taxing saving than consumption uses of income is unfair and economically damaging. There is no meaningful social, let alone economic policy goal that is served by punitively taxing saving; such punitive taxation is not made "fair" because its weight is greater on the rich or on businesses than on others. By reducing the undue tax burden on saving, Title I of H.R. 9 is a welcome initiative for addressing this unfairness.

Institute for Research on the Economics of Taxation.

STATEMENT OF NORMAN B. TURE
PRESIDENT, INSTITUTE FOR RESEARCH ON THE ECONOMICS OF TAXATION (IRET)

CONCERNING TITLE I, H.R. 9
PRESENTED TO
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FEBRUARY 22, 1995

Madam Chairwoman, members of the Committee, I appreciate the opportunity to discuss with you the significant improvement in the federal income tax that will be provided by enactment of Title I of H.R. 9. Both of the principal features of the proposed capital gains reform — the reduction in the marginal tax rates applicable to capital gains and the inflation adjustment of basis — are highly commendable. Their enactment would contribute to moderating the unwholesome income tax bias against saving and would afford promise of additional efforts to eliminate it completely.

Welcome as the Title I provisions are, additional revisions of the capital gains provisions are needed to provide a tax environment less obstructive of economic growth. Let me call the Committee's attention to one such revision at a later point in my statement.

The context of the Small Business Committee's concern with Title I.

Policy makers should keep clearly in mind that business is the vehicle for economic progress, with small businesses providing much of the motive power for that vehicle. Business organizes the activities that convey ideas from drawing boards into deliverable products and services. New products and services and new production processes, major impetuses for economic progress, don't just happen. Making them realities depends on entrepreneurial activity, on the willingness of entrepreneurs to take the risks inherent in launching new ventures. Entrepreneurial infusions keep business, hence the economy as a whole, from stagnating. And while the entrepreneurial spirit is expressed in businesses of all sizes and ages, new and small businesses are extraordinarily important channels through which that spirit is implemented.

This most assuredly is not to state that the merits of Title I should be assessed solely or even primarily in terms of possible benefits for small business. Public policies, certainly including tax policies, should be fashioned to apply as even-handedly as possible. Much of the enormous complexity of the existing tax law is the product of efforts to particularize the law's application to differing types of transactions, differences in taxpayer situations, distinctions among taxpayer attributes, very often to confine tax relief to particular taxpayers. We have had

far too much of this approach to tax policy formulation.

Evaluation of the benefits of Title I, therefore, should not rest on whether any particular group of individual or business taxpayers will benefit more than some other group. Instead, that evaluation should focus on whether Title I will move the tax law toward closer conformity with the critically important criterion of tax neutrality. This criterion calls for minimizing the "excise" effect of taxes — altering the relationships among prices that would result from the operation of the market system free of government influence or intrusion.

The existing tax system falls far short of meeting this standard, particularly with respect to private saving. I believe that it is in this connection that the Committee should be concerned with Title I.

Creating new businesses and implementing innovations requires access to saving. A society that saves a lot will not necessarily be highly entrepreneurial and innovative, but a society that is actively entrepreneurial and innovative must be able to draw on saving that is adequate to finance such efforts. Improving the prospects for small business growth, therefore, depends to an important extent on moderating, if not eliminating completely, the existing tax law's bias against saving.

The Nation has recently been instructed about the imperatives for a larger, more efficient, more rapidly growing economy, one in which the volume of private saving and its share of total income will very substantially exceed those of recent years. The Bipartisan Commission on Entitlement and Tax Reform reported that by about the year 2025 projected entitlement spending under existing federal entitlement programs would exceed the entire amount of revenues projected to be provided under existing tax laws. Federal borrowing to finance the resulting deficit would take up all of the saving of American households and businesses, leaving no saving to capitalize new business or to finance business growth or for investment in private capital formation and other growth-generating private uses.

These projections, even if substantially discounted, highlight the urgency of improving the tax environment for private saving. Title I of H.R. 9 is an important step to that end.

The anti-saving tax bias

The anti-saving, anti-investment bias in the income tax results from the fact that both income that is saved and the income produced by investing that saving are subject to tax, often several times over, while income that is used for current consumption is taxed only once. The consequence is that the amount of current consumption that must be forgone to obtain any given amount of after-tax return on one's saving is greater than if either the income that is saved or the return it produces were excluded from the tax base. The forgone consumption is, of course, the real cost of obtaining that future income. In other words the income tax increases the cost of saving compared to the cost of current consumption. Moreover, the income-tax induced increase

in the relative cost of saving is greater the higher is the tax rate to which the person is subject.[1]

The separate income taxation of income generated in corporate businesses, the income taxation of capital gains, and the transfer (estate and gift) taxes very substantially accentuate the anti-saving bias of the federal tax system.

Moreover, the anti-saving bias is exacerbated by the imposition of the tax on the nominal rather than on the inflation-adjusted returns on saving and investment. The expectation of inflation, *per se*, adversely affects saving and investment. Inflation expectations increase the rate at which the returns on saving must be discounted to determine their amount in real terms; unless the expected nominal returns increase at least as rapidly as the expected inflation rate, the value of the expected *real* returns will be depressed, thereby increasing the cost — the forgone current consumption — of any given amount of real future income.

Taxing nominal capital gains aggravates this effect of inflation in increasing the cost of saving. This effect is likely to be particularly severe in the case of gains realized on the sale of corporate stock the market value of which has not kept pace with inflation. It may well result in taxing real losses, not merely overtaxing real gains that are less than nominal gains.

Taxing realized capital gains also impedes transactions in capital assets. An investor will be reluctant to sell his or her capital assets in order to purchase other assets unless the present value of the expected net returns on the replacement assets exceeds that of the expected returns on the existing holding by enough to defray the tax on any gain realized on the sale of the latter. For any given amount of accrued gain, the higher is the capital gains tax rate, the more imposing is the tax barrier to such changes in the composition of a person's assets.

This locking-in effect tends to impose a kind of toll gate charge on business mergers and acquisition. Effective entrepreneurship often involves moving out of a matured business into new ventures, often by selling the business to others for whom it affords greater opportunities. Taxing the gain realized upon disposition of the business raises the reservation price for the sale and tends, thereby, to deplete the resources that would otherwise be rolled over into new ventures.

The existing tax treatment of capital gains and losses also imposes a barrier to the commitment of saving to innovative, therefore high-risk enterprises. Insofar as such ventures succeed, some of the resulting increase in the saver-investor's equity is taxed away if the saver-investor seeks to sell his or her interest in the enterprise to less venturesome savers and to shift his or her investment to other innovative, high-risk ventures. On the other hand, if the venture is unsuccessful, the saver-investor's loss very often is not fully deductible when realized. The effect is to accentuate the risk of such uses of saving, hence to raise the cost of undertaking such

[1] The appendix to my statement provides a number of simple arithmetic examples that show how the individual and corporate income taxes and the taxation of capital gains raise the cost of saving relative to consumption uses of income.

effect is to accentuate the risk of such uses of saving, hence to raise the cost of undertaking such enterprises.

Benefits from enactment of Title I

Both the proposed exclusion from adjusted gross income of 50 percent of net long-term capital gains and the adjustment for inflation of the basis of capital assets would be significant improvements over the existing law treatment of capital gains. Of these provisions, the 50 percent exclusion is likely to be more significant in improving the tax climate for saving and investment.

Section 1001. 50 percent capital gains deduction

The proposed deduction from adjusted gross income of half of net long-term capital gains has the effect of cutting the marginal tax rates in half for individual taxpayers in the 15 percent and 28 percent brackets and of affording smaller, but still significant percentage reductions in the capital gains tax rates for people in higher brackets. For corporations, the proposed deduction would cut the top effective marginal rate on capital gains to 17.5 percent from 35 percent. These rate reductions would mitigate the adverse effects, discussed above, of the existing tax treatment.

Reducing the tax bias against saving

The fundamental economic benefit that would be realized from enactment of Title I would be the reduction in the severe bias against saving imposed by the existing federal tax system, particularly the personal and corporate income taxes. Although even outright elimination of the capital gains tax would not fully rid the tax system of its anti-saving, anti-investment bias, the proposed 50 percent gain deduction would make an important contribution in moving the tax system in the direction of neutrality between saving and consumption uses of income. It would, in other words, significantly reduce the extra cost of saving relative to consumption.

This highly desirable effect on the cost of saving would not be confined, it must be stressed, to saving invested in capital assets, as defined in the Internal Revenue Code. In an efficiently operating capital market, changes in market valuations in response to tax changes impel reallocations of saving until risk-adjusted net-of-tax returns are substantially equalized among all assets. Reducing the marginal tax rate on capital gains will reduce the cost of saving invested not only in capital assets but in all other uses, as well. Similarly, this cost reduction will not be limited to the activities, businesses, or industries that are heavily invested with capital assets, as defined in the tax code.

One of the major benefits of the higher levels of saving that is likely to result from enactment of Title I is that the work force will enjoy a greater endowment of all sorts of capital, particularly more technically advanced capital. The consequence is greater labor productivity that will enhance the efficiency of virtually all business activity.

developments is not readily determinable, but neither is this an appropriate public policy concern. The distribution of these benefits should be determined by market operations, not by government dicta. Public policy should not attempt to target particular activities, businesses, industries, or taxpayers for government-granted benefits or incentives. Policy makers should realize that every such selective benefit or incentive raises the costs confronting those who are not the favored targets. These are the real costs of selective tax or spending measures, costs that are never considered in government cost-benefit analyses.

The desirability of the 50 percent deduction and consequent reduction in marginal tax rates on capital gains does *not* depend on how large the saving response to the overall lower cost of saving will be. The objective of this reform is to reduce the existing anti-saving tax bias, not to dictate to households or businesses what uses they make of their income claims and property rights. Reducing capital gains taxes is constructive tax policy whether the resulting increase in saving is great or small.

Having said this, I believe that reducing taxes on capital gains will indeed result in significantly more saving than would otherwise be undertaken. Sound economic analysis urges that tax changes that reduce the cost of saving relative to consumption uses of income will lead to higher levels of saving than would otherwise occur. Opponents of capital gains tax reform insist that saving behavior is little if any responsive to changes in the cost of saving. They obviously fail to note that in making that assertion they are also maintaining that consumption behavior is little if any responsive to changes in its cost. In other words, according to these folks, people and businesses pay no attention to taxes in deciding anything about their economic activities. The Committee should recognize in this viewpoint a license for imposing any amount of any kind of taxes without regard for the damage that will result.

Improving capital market efficiency

Reducing the marginal rate of tax on capital gains will also ease the lock-in effect described above. It will, therefore, reduce the existing tax impairment of the market's function in facilitating the exchange of property rights, hence the market's efficiency. This enhancement of market efficiency is a very important benefit to be obtained from the proposed reduction in marginal tax rates on capital gains, irrespective of the magnitude of the change in the amount of gains realized.

As mentioned above, the lock-in effect of existing capital gains treatment erects barriers to the efficient transfer of business ownership. The proposed 50 percent reduction in the corporate capital gains tax rate will materially reduce this barrier and facilitate changes in corporate ownership as well as free up individuals' property holdings.

One of the most informative indicators of the surging dynamism of the U.S. economy is the ongoing business restructuring, involving major changes in the ways in which companies do business. Very often, business restructuring efforts, aimed at taking advantage of opportunities for productivity enhancement, lead to changes in company ownership. One of the costs of those

changes is the tax on the capital gains that may be realized in the process. Reducing that tax wedge will facilitate productivity-enhancing corporate restructuring. It is, therefore, extremely important to retain the inclusion of corporate capital gains within the purview of Title I.

Section 1002. Indexing the bases of capital assets for purposes of determining gain or loss

Adjusting the bases of assets for purposes of determining gain or loss upon the disposition of the assets would avert accentuating the income tax's anti-saving bias in an inflationary environment. Clearly, this proposed change in the tax treatment of capital gains and losses would be inconsequential in an economic setting in which savers were absolutely confident that no inflation would occur over the time period that is relevant for their saving-investment decisions. By the same token, it would afford greater benefits the higher is the expected rate of inflation. Even if the expected inflation rate is quite modest, however, adjusting asset bases for inflation will forestall the adverse effect of the risk of inflation on saving and investment, discussed earlier in this testimony.

Indexing the bases of capital assets for inflation will also contribute, clearly, to freeing up currently locked-in savings. It will, therefore, make an important contribution to enhancing the efficiency with which the capital market performs its functions.

This is not to say that the indexing proposal is free of problems. For one thing, in the case of financial assets such as corporate common stocks, the proposed basis adjustment would apply as a rule only to the initial investment. The proposed indexing would not apply to the additions to basis represented by the corporation's retaining and reinvesting some of its after-tax earnings. The proposed indexing, accordingly, would apply to a smaller and smaller share of the accumulating basis of the stock the longer the stock is held, leaving larger and larger amounts of nominal gains exposed ultimately to tax. I hope the Committee on Ways and Means will address this deficiency.

I also hope that the Committee on Ways and Means will extend indexing of basis for purpose of determining gain or loss on the disposition of equipment subject to a net lease. The differences in contractual arrangements for the acquisition and use of property in a trade or business should not enter into determination of the eligibility of property for the inflation adjustment of basis. Even under modest inflationary expectations, denying this basis adjustment to property subject to a net lease would expose lease arrangements to a significant market place disadvantage with no discernible gain concerning tax principles.

As this Committee knows, small businesses rely relatively heavily on leasing, rather than purchasing, various types of equipment, as well as business premises. Excluding property subject to a net lease from the indexing provisions of Title I would keep the costs of such property unduly high.

One of the major deficiencies of the existing tax treatment of capital gains and losses is their asymmetrical treatment. For individuals, the taxable capital gains realized in any year are fully subject to tax in that year, but net capital losses are not fully deductible in the year in which they are realized. Instead, net capital losses may offset no more than $3,000 of ordinary income in the year in which they are realized. Unused capital losses may be carried forward until fully used up, but they may not be carried back. Since a dollar in the future is less valuable than a dollar today, this accentuates the asymmetry in the tax treatment of losses compared with gains.

Even harsher is the treatment of capital losses sustained by corporations. Corporations may offset capital losses realized in any particular year against the capital gains realized in that year, but none of these losses may be offset against ordinary income. Unused losses may be carried back up to three years and carried forward up to five years.

I discussed briefly above the benefits that Title I will afford in reducing the capital gains tax barrier to the changes in property and business ownership that is the hallmark of a dynamic economic environment. These changes do not always result in capital gains for the parties to the transactions. The existing law limitations on the deductibility of capital losses, particularly in the case of corporations, significantly impede the transfers of property rights to their more productive uses and thereby blunt efficient response to the opportunities and challenges continuously arising in a dynamic business environment. It is to be hoped that the Ways and Means and Committee will address this deficiency of existing law.

Dividend tax relief

Desirable as I believe to be the capital gains tax reforms, their enactment will tend to bias corporate decisions in favor of retaining after-tax earnings rather than distributing them as dividends to shareholders. As noted earlier in this discussion, the fact that the tax on capital gains is deferred until the gains are realized somewhat abates the punitive effect of taxing income generated by corporate businesses both to corporations and their shareholders. There can be little doubt that this somewhat influences corporate distribution policies, although the magnitude of this influence is by no means certain.[2] Expanding the differential in effective tax burdens on retained vs. distributed earnings by reducing capital gains taxation urges integration of the income taxation of corporations and their individual owners. An initial step in this direction would be to provide some relief at the corporate level for dividend distributions.

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[2] In the last decade and a half, an important academic literature has been produced that strongly suggests that some of the serious problems of corporate governance noted during the 1980s are attributable to corporate executives' efforts to maximize their welfare at the expense of maximizing the net worth of corporate owners. Excessive retention of corporate earnings may have contributed to these problems.

"Fairness"

Finally, a word about the "fairness" issue. Congressional consideration of tax proposals aimed at reducing tax barriers to saving, capital formation, and entrepreneurship has far too often been blocked by redistributionist assertions that such proposals are unfair because they would benefit rich people and/or business. It is well past time for policy makers to recognize that the goodness or badness of a policy does not depend on the specific attributes of the people who are immediately affected by them. A tax change that reduces the existing tax penalty on saving compared with consumption uses of income is not unfair because it may well more substantially reduce the tax liabilities of people who pay a great deal of taxes and who will greatly increase their saving in response to the tax change than it will the taxes of people who pay little or no taxes.

There is no meaningful social, let alone economic policy goal that is served by punitively taxing saving; such punitive taxation is not made "fair" because its weight is greater on the rich or on business than on others. And when one considers that the principal beneficiaries of increases in saving, capital formation, entrepreneurship, and other growth generating activities are labor and consumers, redistributionist objections to easing the differentially heavier tax burdens on these various activities should be dismissed out of hand.

Addressing the unfairness in more heavily taxing income that is saved than income used for current consumption promises substantial dividends in higher standards of living for everyone. Title I of H.R. 9 is an effective beginning.

APPENDIX

Basic Income Tax Bias Against Saving

Pretend, for a moment, a no-tax world in which someone earns an extra $1,000. The person can either use the $1,000 for additional consumption or to purchase a perpetuity — a bond with no maturity date — paying, say, 10 percent a year. The person's choice is to enjoy $1,000 of additional consumption now or to have an additional $100 of income every year. The cost of each dollar of the additional income — the forgone consumption — is $10.

Now assume an income tax of the same basic configuration as the existing income tax is levied at a rate of, say, 25 percent. On the additional $1,000 of current income there is a tax of $250, leaving the person with $750 after tax that can be used either to buy an additional $750 of current consumables or a $750 bond paying 10 percent a year. Of course, the $75 of interest on the bond is also subject to the income tax, so that the after-tax income on the saving is $56.25. The person's choice is $750 more of current consumption or $56.25 more income each year. The cost — the forgone consumption — per dollar of that additional interest income is $13.33. The income tax increased the cost of obtaining future income compared to the cost of current consumption by 33.33 percent.

As noted in the text, this tax-induced increase in the cost of saving compared to that of current consumption is greater the higher is the marginal tax rate to which the person is subject. Suppose the tax rate to be paid by the person in the example were 40 percent instead of 25 percent. In this case, the income tax would increase the cost per dollar of additional future income from $10 to $16.67 or by 66 2/3 percent.

Additional bias imposed by the corporate income tax

Suppose that instead of buying a bond, the person in the example were to invest the additional income in corporate stock, and suppose the earnings per share were also 10 percent of the investment. Suppose the corporate tax rate were 35 percent and that the corporation were to distribute all of its after-tax earnings. In this case, the 25 percent bracket taxpayer would net $36.56 each year, for which he or she would have to forgo $750 of current consumption; the combined corporate and individual taxes raise this person's cost per dollar of additional future income from $10 to $20.51, a little more than 100 percent. If the person were in the 40 percent bracket, each net-of-tax dollar of return on his or her investment would cost $25.64 of forgone consumption, more than 150 percent more than in the absence of taxes.

The capital gains tax bias against saving

Suppose that the corporation retains its after-tax earnings and reinvests them in assets producing the same rate of return as before. Also suppose the 25 percent tax bracket person in our example held the stock for, say, five years before selling it. By assumption, the value of the stock will have increased from $750 to $1,027.57. On the gain of $277.57 realized on the

person's sale of the stock, he or she owes $69.39, leaving an after-tax gain of $208.18. The same result would be obtained if the person were to receive an after-tax annuity of $43.48 over the five year period. With this tax treatment, the cost per dollar of future income, in terms of forgone current consumption, is $17.25 [3] Although the deferral of tax until the capital gain is realized imposes less of a tax penalty on saving than in the former case, it nevertheless substantially raises the cost of obtaining future income, in this example by 72.5 percent, compared to the cost in a no-tax world.

Section 1001 of H.R. 9 would significantly reduce the cost of saving compared with present law. If the person in the example were required to include only half of the net long-term gain in taxable income, the capital gains tax due upon the sale of the stock at the end of five years would be $34.70, leaving a net gain of $242.87. The same result would be obtained had the person received an after-tax annuity over the five years. In this case, the cost per dollar of future income would be $15.25 or 52.5 percent more than in a no-tax world but significantly less than under the existing tax treatment.

[3] The cost of future income, in these terms, would be lower the longer the person deferred realization of the capital gain.

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February 27, 1995

The Honorable Jan Meyers
Chairman, House Small Business Committee
2361 Rayburn Building
Washington, DC 20515

Dear Congresswoman Meyers:

I am writing on behalf of the over 5,500 U.S. members of the North American Equipment Dealers Association to urge your support of legislation to reduce the capital gains tax rates and to index capital gains for inflation.

NAEDA's members are the farm, industrial and outdoor power equipment dealers located throughout the nation. With an average of 17 employees per dealership, they are often among the largest employers in their communities.

As with every business, investment is critical to the success of a dealership. Raising capital is often more difficult in the smaller communities where most dealers are located--but it is difficult for small businesses anywhere. Today, capital gains tax rates create a disincentive to continue pouring human and financial capital into the dealership and other businesses. Indeed, the opposite should be the case--dealers and other small businesses should be encouraged to form, to grow, and to employ. The benefit NAEDA's dealers provide to their communities is not merely service to their customers. It is also stable employment at fair wages for over 90,000 Americans.

Encouraging investment in small business is good for America, and particularly for rural America. Before you is the opportunity to provide that encouragement by reducing the capital gains tax rate and indexing future gains for inflation. I urge your support.

Sincerely,

John J. Mullenholz

Overreaching on Capital Gains

A complex proposal to lower the tax rates nearly to zero

BY JANE BRYANT QUINN

THEY MUST BE KIDDING. THE GOP IS PROPOSing a cut in the capital-gains tax that appears to improve on the miracle of the loaves and fishes. Judging from everything I'm told, slashing this tax will boost savings, spur growth, cut the budget deficit, end poverty, cure hair loss and stop my kids from biting their nails.

Anyone with taxable profits in real estate or stocks will love this remarkable proposal, which can cut the average capital-gains tax almost to zero (table). As a practical matter, however, the bill is a Newtron bomb. Its appalling complications would add volumes to the tax regulations and hours to your paperwork. The cuts—far too deep to pay for themselves in revenue growth—are projected to add from $54 billion to $61 billion to the federal deficit over five years And the rules invite tax-shelter abuse. You'd have another chance to blow your life savings on Wall Street frauds, in case you missed it the last time around.

The rules invite the return of costly shelter abuse

Leaving aside for a moment the merits of slashing the tax, take a look at how this sucker computes.

One part is easy. Half of all your long-term gains (on investments held for more than a year) would be sheltered entirely from tax. The mischief lies in the other part. It adjusts your investments by the quarterly inflation rate, going back to the end of 1994. For example, say that you ran a $1,000 investment up to $1,600 and during that time inflation rose by 10 percent. Today, you'd be taxed on the full $600 profit. Under the GOP proposal, your original cost would be scaled up to $1,100 (the 10 percent inflation adjustment)—leaving you a reported gain of only $500. Half of that amount, $250, would be subject to tax.

Not simple: Backers of the bill say it's fair to quit taxing "false" gains that merely offset your losses to inflation. But surely, sheltering half the profit is enough to achieve that end. Indexing isn't nearly as simple as it sounds, says Michael Schler, tax partner at the New York law firm of Cravath, Swaine & Moore. Try these examples on for size:

■ If you reinvest mutual-fund dividends, every reinvestment would have to be figured at a different inflation rate. The mutual fund could use indexing, too, so detailed rules would be needed to coordinate its inflation adjustments with those of its various investors.

■ Bonds are not indexed. If you had a stock-and-bond fund, your inflation adjustment would be keyed to the percentage of stocks in the fund's portfolio each month.

■ If you own your home, every home improvement is treated as a reinvestment. But for long building projects, time would become an issue. If you added a deck and paid for it over two calendar quarters, you'd have to allocate the cost and index it at two different rates.

■ For partnerships and corporations . . . never mind. It's too disheartening to go on. Didn't you say that you wanted the government off your back?

The tax-shelter angles will gladden any hungry heart. To take a plain example, the GOP plans to index assets but not debts. I could get a $10,000 home-equity loan at 8 percent interest and buy a shelter with an 8 percent yield. Later, I'd sell for $10,000 and repay the loan. The income from the shelter would cover my interest, so my only cost is this shell game's expenses. But with 3 percent inflation, I'd win a $300 tax loss to play with. Under the bill, half the loss could offset ordinary income; the full loss could still offset capital gains. Enforcing compliance would be a nightmare, as shelter mavens sought to convert unindexed assets into capital gains.

The proposed tax cut raises other issues, too. For example, it's glaringly inefficient. It favors stocks over bonds, real estate over bank accounts and certain types of business investment: a government interference in the market's normal allocation of capital.

Backers continue to insist that lower taxes on capital gains will raise the number of transactions and produce more government revenue. That did indeed happen after the four cuts made since 1978. But in other years, transactions and revenues rose after tax rates were *increased*, so investors aren't moved by rates alone. The best evidence suggests that cuts in the tax rate affect market-timing decisions ("Shall I sell this stock now or not?") but not necessarily long-term decisions ("This is a stock I bought for keeps"). One thing's for sure: it's hard to raise money from tax rates that descend to zero. Studies by Jane Gravelle of the Congressional Research Service suggest that the ultimate cost of this tax cut will be much higher than what's projected now.

Indisputably, this tax cut indulges the rich. Of all net long-term capital gains reported to the IRS, including gains on homes, 51 percent go to taxpayers with incomes topping $200,000, although this group accounts for less than 1 percent of all tax returns. Only 21 precent go to those with incomes under $50,000. Capital-gains cuts do *not* affect your retirement plans, withdrawals from which are taxed as ordinary income.

Anyone who mentions the tilt toward wealth gets attacked for wanting to "punish the successful" (*successful* being defined as rich). I'd put it another way: the rich owe more than others to the system that has freed them to earn so much. Some preference for capital gains makes sense; a low cost of capital promotes economic growth, says Arthur Hall, senior economist of the Tax Foundation. But this giant tax cut will have to be funded with bloody cuts in government spending. Better to whack at the deficit instead.

A Taxing Proposal

Under the plan, profits on stocks, real estate and tangible investments would be lightly taxed or not taxed at all. Here's the outcome for a $10,000 investment, held for five years under 3 percent inflation* by someone in the 31 percent bracket.

		CURRENT		PROPOSED	
ANNUAL GAIN	DOLLAR GAIN	TAX OWED	EFFECTIVE TAX RATE	TAX OWED	EFFECTIVE TAX RATE
2%	$1,041	$291	28%	$0†	0
6%	3,382	947	28%	277	8.2%
10%	6,105	1,709	28%	699	11.4%

*15.9% OVER 5 YEARS †CREATES AN $56 TAX BENEFIT
SOURCE: MICHAEL SCHLER, CRAVATH, SWAINE & MOORE

Reporter TEMMA EHRENFELD

STATEMENT OF LESLIE B. SAMUELS
ASSISTANT SECRETARY (TAX POLICY)
BEFORE THE
COMMITTEE ON SMALL BUSINESS
UNITED STATES HOUSE OF REPRESENTATIVES

Madam Chair and distinguished Members of the Committee:

I am pleased to present the views of the Administration on the effect on small business of certain capital gain tax proposals and expensing proposals in H.R. 9, the "Job Creation and Wage Enhancement Act." H.R. 9 contains three capital gain tax provisions: (i) a provision allowing all taxpayers to deduct 50 percent of net capital gains from gross income effective January 1, 1995; (ii) a provision allowing taxpayers to index the basis of corporate stock and certain tangible assets for inflation after January 1, 1995 in determining gains and losses; and (iii) a provision repealing the current 50 percent exclusion for gains on certain small business stock. In general, these provisions broaden the capital gain exclusion beyond the current exclusion for qualified small business stock. There are, however, certain adverse effects on small businesses that may not have been noted by proponents of the provisions.

This Administration has strongly supported prior legislation specifically targeted at assisting capital formation for small businesses. In the Omnibus Budget Reconciliation Act of 1993 (OBRA '93), the Administration proposed and supported Section 1202, which provides a 50 percent exclusion for capital gains resulting from the sale of qualified small business stock. This provision created a preference for investments in small business stock by reducing the effective tax rate on qualified investments to 14 percent (28 percent applicable rate times 50 percent exclusion). This preferential rate was designed to increase capital flow to small businesses. The provision was carefully drafted to ensure that the benefits would be limited to small businesses, thereby preserving the intended preference for such businesses.

The Administration also supported the OBRA '93 increase in the amount of capital investment that small businesses can currently deduct under Section 179 from $10,000 to $17,500. This increase allows small businesses to deduct the cost of investment immediately, rather than over the recovery life of the acquired assets. In addition, the Administration supported the OBRA '93 enactment of Section 1044, which encourages investment in small businesses by allowing taxpayers to postpone gain recognition from the sale of publicly traded securities if the gain is invested in specialized small business investment companies.

The Administration's support of small business has not been limited to legislation. The Administration continues to issue tax regulations that assist small businesses in several ways. The Administration routinely issues regulations designed to minimize or eliminate burdensome record-keeping requirements on small businesses. For example, the Administration recently issued regulations reducing the reporting requirements necessary to claim an ordinary loss deduction on the sale of small business stock, even though the courts have consistently denied a deduction to taxpayers who did not fully complied with the regulations. Recent regulations have also simplified the calculations involved in computing the Alternative Minimum Tax (AMT) liability of individuals. These new regulations should simplify the return preparation for most taxpayers subject to the AMT, including small businesses. In addition, recent regulations have allowed taxpayers to group certain assets in one or more "general asset accounts," which will simplify the calculations for determining the amount of depreciation deductions for small businesses.

The Administration has also issued guidance designed to assist small businesses in complying with complicated tax provisions. For example, the Administration recently issued a revenue procedure clarifying the circumstances in which a "limited liability company" will qualify as a partnership for Federal tax purposes. This revenue procedure will greatly assist the rapidly growing number of small businesses that elect to operate as limited liability companies. In addition, comprehensive regulations have recently been issued under Section 1374 resolving many of the complicated issues involved in calculating the built-in gain of a corporation that converts to a small business S Corporation. Recent regulations have also greatly simplified the application of the passive loss restrictions to small businesses.

The Administration continues to issue regulations that resolve uncertain or ambiguous tax issues. For example, many taxpayers were concerned that their employees would have to report the non-deductible portion of business meals and entertainment as income. The Administration resolved this uncertainty by clarifying that the employees did not have any

income, so long as there was a business purpose for the expense. The Administration has also issued regulations clarifying that small investment partnerships, including family partnerships, can take advantage of a simplified form of accounting for the built-in gains or losses on their securities.

The Administration continues to exempt small businesses from many of the more complicated income tax regulations, particularly regulations dealing with complex accounting provisions. For example, the recent hedging regulations provide that the rules governing the timing of hedging gains and losses do not apply to small cash method taxpayers, even though such taxpayers are given the benefit of the favorable character provisions in those regulations. The mark-to-market regulations also contain an exception for taxpayers with relatively low levels of sales activity. The recent uniform capitalization rules also provide a de minimis rule for small businesses.

Capital Gain Reduction

It is because of its efforts to encourage capital flows to small business that the Administration is concerned about the capital gain and indexing provisions in H.R. 9. As noted earlier, Section 1202 currently allows a 50 percent exclusion for capital gains on the sale of qualified small business stock. This section was carefully drafted to ensure that it would encourage investment in small businesses and would be limited only to investments in such small business stocks. For example, the preference applies only to certain small business stock purchased directly from the business (or through an underwriter) at the time of issue and held for at least five years. Corporations eligible for this preference must have assets (including funds from the stock issue) of under $50 million and must meet certain other conditions. The amount of gain eligible for the 50 percent exclusion is limited to the greater of ten times the taxpayer's basis in the stock or $10 million. One-half of the excluded gains are treated as a preference for purposes of the Alternative Minimum Tax (AMT).

H.R. 9 would allow individuals and corporations to deduct 50 percent of all net capital gains from gross income. This provision will have three effects on small businesses. First, by extending the 50 percent exclusion to all capital assets, H.R. 9 will eliminate the current preference in Section 1202 for small business stock.

Second, instead of merely eliminating the current advantage held by small businesses, H.R. 9 would actually increase the tax rate on certain gains from investments in eligible small businesses. The current maximum tax rate for individuals on investment in small businesses that qualify for the Section 1202

preference is 14 percent (maximum capital gain rate of 28 percent times 50 percent exclusion).[1] H.R. 9 would eliminate the 28 percent maximum tax rate on capital gains of individuals. As a result, H.R. 9 would impose a maximum tax rate of 19.8 percent (39.6 percent maximum rate times 50 percent exclusion) on investments that currently qualify for the 14 percent preferential rate under Section 1202. A 14 percent rate in a 28 percent rate environment is relatively attractive to investors in small businesses, compared to a flat 19.8 percent rate on all capital gains.

Third, the current preference in Section 1202 applies to any gain from the sale of qualified small business stock, but the capital gain exclusion in H.R. 9 applies only to "net capital gain" (the excess of net long-term capital gains over short-term capital losses). As a result, an investor in qualified small business stock would receive no capital gain preference under H.R. 9 to the extent that the taxpayer had short-term or long-term capital losses.

Indexing

H.R. 9 would allow individuals and corporations to index the basis of corporate stock and certain tangible assets for inflation after January 1, 1995 in computing gains and losses. The Administration opposes the indexing proposal because of its complexity and because of the increased potential for significant tax avoidance.

Small businesses would receive little benefit from indexing, as compared with larger companies, for two reasons. First, investment costs incurred by small businesses are and should continue to be eligible for generous expensing deductions. As a result, small business assets generally have very little or no tax basis to index. In addition, small businesses are often capitalized as much with the work efforts of the owner, so-called "sweat equity," as with capital. The indexing proposal provides no benefit for these non-cash contributions to small businesses. Second, under the indexing proposal, any business engaging in even a relatively simple transaction, such as the sale of a building, would be forced to comply with new record-keeping requirements that could require many to consult accountants and

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[1] Because one-half of the excluded gain is treated as a preference for AMT purposes, the actual rate could be higher for certain taxpayers subject to the AMT, but would never exceed 21 percent.

lawyers to prepare their tax returns. The complexity increases substantially for other transactions.[2]

Increased Expensing Limit for Small Business

The Administration supports the provision in H.R. 9 that increases the amount of investment that can be currently expensed by small businesses on a revenue-neutral basis. In general, the cost of business or income-producing property that provides services for more than one year must be deducted over the recovery period of the property. A taxpayer may elect under Section 179 to deduct currently up to $17,500 of the cost of the property. This $17,500 maximum is reduced for each dollar of the total cost of qualified property acquired during the year in excess of $200,000. As a result, the benefit of Section 179 is generally limited to small businesses.

H.R. 9 would increase the maximum investment that may be currently deducted from $17,500 to $25,000 for tax years beginning in 1996. The Administration supported the increase in the maximum from $10,000 to $17,500 in OBRA '93, as well as the increase to $25,000 contained in the House of Representative's version of that bill. Accordingly, the Administration supports, as it did in 1993, the increase proposed in H.R. 9 on a revenue-neutral basis.

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[2] As the Joint Committee on Taxation recently noted in a report to the Senate Committee on Finance, "indexing would involve a significant amount of record-keeping" and "would substantially increase the number of calculations necessary to calculate taxable gain for many common transactions." Staff of Joint Committee on Taxation, 104th Cong., 1st Sess., Report on Tax Treatment of Capital Gains and Losses Scheduled for Public Hearings by the Senate Committee on Finance 26 (February 13, 1995).

ISBN 0-16-047328-4
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